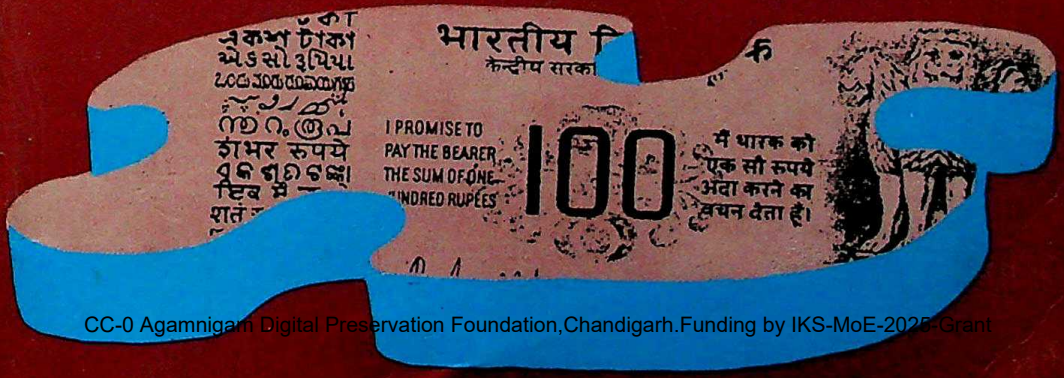
Gandhi Memorial College Of Education,Bantalab,Jammu

FOURTH REVISED EDITION

MERCANTILE LAW

M C KUCHHAL

BENTLEY VS CRAVEN
NEGOTIABLE INSTRUMENTS ACT
BALFOUR VS BALFOUR
KREIL VS HENRY
HADLEY VS BAXENDALE
ARTNERSHIP ACT
CHINAYYA VS RAMAYYA
SALE OF GOODS ACT
CONTRACT ACT



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By the same author :

SECRETARIAL PRACTICE
MODERN INDIAN COMPANY LAW
ADHUNIK BHARTIYA COMPANY ADHINIYAM
VANIJYIK VIDHI
BUSINESS LAW

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MERCANTILE LAW

[For B. Com., M.Com, C.A., I.C.W.A., C.S., M.B.A., L.L.B., Banking and Competitive Examinations]

M.C. Kuchhal
Department of Commerce
Shri Ram College of Commerce
University of Delhi, Delhi

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To

my inquisitive students

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Preface

Any book going through more than a dozen editions/reprints speaks for its own merits. It needs no introduction to its prospective readers. Apart from the appreciation this book has received from its readers, the National Book Trust India, New Delhi, subsidized the publication of its 1981, 1982 and 1984 editions/reprints in recognition of its usefulness to the students.

In this revised edition the text has been thoroughly revised without disturbing the basic structure of the book. In the process of revision, new legal provisions have also been incorporated to update the text material. Legal arguments at many places have been re-inforced with added reasoning. More illustrations have been added to further explain the complicated legal provisions. Besides, at points, not-so-important elaborations have been deleted to make room for more important explanations with a view to maintaining the manageable size of the book. I hope that this book will continue to prove of immense utility to the students whose interest has always been kept in view.

I would like to express my gratitude to the students and teachers for their unqualified approbation of the book.

M.C. KUCHHAL

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Preface to the First Edition

Mercantile Law is a growing subject. It comprises laws of practical importance in the modern business world. Hence the study of Mercantile Law has been given a high priority for Commerce and Law education by our universities and professional institutes. There is no dearth of literature on the subject. However, there still seems to be a need for a work which unfolds in an easily comprehensible manner the intricate points of the law and seeks to answer the tricky questions which might intrigue the mind of a curious reader. It is with this feeling that the present text has been written.

This book explains the fundamental principles of the subject and presents a comprehensive, coordinated, cohesive and accurate exposition of its statutory provisions in a lucid manner. Besides, the presentation is easy to grasp since each complicated provision has been explained with the help of illustrations and analogies.

The subject-matter has been organised in eight parts dealing with the laws relating to Contracts, Sale of Goods, Partnership, Negotiable Instruments, Insurance, Insolvency, Carriage of Goods, and Arbitration. The Chapters have been designed to explain topic-wise the statutory provisions, grouping together the relevant Sections. Both English and Indian decided cases have been cited at appropriate places with a view to securing the necessary authenticity and clarity of the subject. Test questions and practical problems along with the hints to solutions thereof have been given at the end of each chapter to enable the readers to evaluate their understanding of the subject.

The book is intended for the students preparing for B.Com., C.A., I.C.W.A., M.B.A., Institute of Company Secretaries, Institute of Bankers, and other competitive examinations.

I am grateful to Dr. C.B. Gupta, Principal of our College, for his guidance. I am thankful to my friends and colleagues B.D. Agarwal, J.L. Gupta, B.P. Singh, B.B. Lal, D.N. Dwivedi, P.S. Mathur, J.R. Monga and N.K. Jain for their helpful suggestions. I also express my gratitude to the various authorities on the subject, both English and Indian, on whose works I have heavily drawn in preparation of this book. I also wish to express my appreciation for the cooperation and enduring patience of my wife in making this venture a success.

M.C. KUCHHAL

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Introduction

Definition of Law

According to the Oxford English Dictonary the word 'Law' means "rule made by authority for the proper regulation of a community or society or for correct conduct in life." In the words of Woodrow Wilson, "Law is that portion of the established habit and thought of mankind which has gained distinct and formal recognition in the shape of uniform rules backed by the authority and power of the Government." Broadly speaking, the term 'Law' denotes rules and principles either enforced by an authority or self-imposed by the members of a society to control and regulate people's behaviour with a view to securing justice, peaceful living and social security.

With the growth of civilisation people's social and economic behaviour has assumed a multi-dimensional character. It is therefore neither desirable nor feasible to control all kinds of people's activities through a uniform set of rules and principles. Most civilised societies therefore provide and enforce different sets of rules and guiding principles for different kinds of social behaviour. Hence there are several branches of law, such as International Law, Constitutional Law, Criminal Law, Civil Law, Mercantile or Business Law, etc. In this book, we shall confine our discussion only to the last of the aforesaid branches of law, namely, Mercantile or Business Laws as they exist in India.

Definition and Scope of Mercantile or Business Law

The term 'Mercantile Law' may be defined as that branch of law which comprises laws concerning trade, industry and commerce. It is an ever growing branch of law with the changing circumstances of trade and commerce.

With the increasing complexities of the modern business world, the scope of Mercantile Law has enormously widened. It is generally understood to include the laws relating to Contracts, Sale of Goods, Partnership, Companies, Negotiable Instruments, Insurance, Insolvency, Carriage of Goods, and Arbitration.

The need for the knowledge of law cannot be over-emphasised. It is common knowledge that *ignorance of law is no excuse,* which implies that

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it is not open to a person committing the breach of law to plead ignorance of law. The breach of law is omission to do something for which the law casts an obligation upon the person to do or doing something which the law refrains. That is why it is generally known and accepted that *every person is presumed to know the law*. As such it is indispensable for the people engaged in economic and commercial pursuits to acquaint themselves with the general principles of the basic business laws.

Growth and Sources of Mercantile or Business Law

Prior to the enactment of the various Acts constituting Mercantile Law, business transactions were regulated by the personal laws of the parties to the suit. The rights of Hindus and Muslims were governed by their respective laws and usages. Where both parties were Hindus, they were regulated by the Hindu Law and where both parties were Muslims, the Mohammadan Law was applied. In cases where one party was a Hindu and the other was a Muslim, the personal law of the defendant was applied. In case of persons other than Hindus and Muslims, and also where laws and usages of Hindus or Muslims were silent on any point, the courts generally applied the principles of English Law.

Gradually, need for the enactment of a uniform law regulating the contracts was realised and this gave birth to the Indian Contract Act, 1872. Since then a number of statutes have been enacted, *viz.*, The Negotiable Instruments Act, 1881; The Sale Goods Act, 1930; The Indian Partnership Act, 1932; The Insurance Act, 1938; The Arbitration Act, 1940, etc.

The main sources of Indian Mercantile Law are as follows:

1. **English Mercantile Law.** The English Mercantile Law constitutes the foundation on which the super-structure of the Indian Mercantile Law has been built. Even now, despite the enactment of various statutes relating to matters falling within the purview of the Mercantile Law, our courts generally take recourse to the English Law where some principles are not expressly dealt wihin an Act, or where there is ambiguity.

2. **The Statute Law.** When a Bill is passed by the Parliament and signed by the President, it becomes an 'Act' or a 'statute'. The bulk of Indian Mercantile Law is Statute Law. The Indian Contract Act, 1872; The Negotiable Instruments Act, 1881; The Sale of Goods Act, 1930; The Indian Partnership, Act, 1932; The Companies Act, 1956 are instances of the Statute Law.

3. **Judicial decisions or Case Law.** Judicial decisions are usually referred to as precedents and are binding on all courts having jurisdition lower to that of the Court which gave the judgement. They are also generally followed even by those of equal jurisdiction in deciding similar points of law. Whenever an Act is silent on a point or there is ambiguity, the judge

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has to decide the case according to the principles of justice, equity and good conscience.

4. **Customs and usages.** Custom or usage of a particular trade also guides the courts in deciding disputes arising out of mercantile transactions, but such a custom or usage must be widely known, certain and reasonable, and must not be opposed to any legislative enactment. But where a statute specifically provides that the rules of law contained therein are subject to any well recognised custom or usage of trade, the latter may over-ride the statute law.

TEST QUESTION

1. Define the term 'Mercantile/Business Law'. What are the main sources of Mercantile/Business Law in India ?

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PART I

Law of Contract

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Chapter 1

Nature and Kinds of Contracts

Introduction

The law of contract is the foundation upon which the superstructure of modern business is built. It is common knowledge that in business transactions quite often promises are made at one time and the performance follows later. In such a situation if either of the parties were free to go back on its promise without incurring any liability, there would be endless complications and it would be impossible to carry on trade and commerce. Hence the law of contract was enacted which lays down the legal rules relating to promises: their formation, their performance, and their enforceability. Explaining the object of the law of contract Sir William Anson observes: "The law of contract is intended to ensure that what a man has been led to expect shall come to pass; that what has been promised to him shall be performed".

The law of contract is applicable not only to the business community, but also to others. Everyone of us enters into a number of contracts almost every day, and most of the time we do so without even realising what we are doing from the point of law. A person seldom realises that when he entrusts his scooter to the mechanic for repairs, he is entering into a contract of bailment; or when he buys a packet of cigarettes, he is making a contract of the sale of goods; or again when he goes to the cinema to see a movie, he is making yet another contract; and so on.

Besides, the law of contract furnishes the basis for the other branches of Mercantile Law. The enactments relating to sale of goods, negotiable instruments, insurance, partnership and insolvency are all founded upon the general principles of contract law. That is why the study of the law of contract precedes the study of all other sub-divisions of Mercantile Law.

The Indian Contract Act, 1872[1]

The law of contract in India is contained in the Indian Contract Act,

[1]Throughout Part I of this book, which deals with the Law of Contract, the references to Sections, unless otherwise specially stated, are references to Sections of the Indian Contract Act, 1872. The word 'Act' wherever used means the Indian Contract Act, 1872.

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1872. This Act is based mainly on English Common Law which is to a large extent made up of judicial precedents. (There being no separate Contract Act in England). It extends to the whole of India except the State of Jammu and Kashmir and came into force on the first day of September 1872. The Act is not exhaustive. It does not deal with all the branches of the law of contract. There are separate Acts which deal with contracts relating to negotiable instruments, transfer of property, sale of goods, partnership, insurance, *etc.* Again the Act does not affect any usage or custom of trade (Sec. 1).

Scheme of the Act. The scheme of the Act may be divided into two main groups:

1. General principles of the law of contract (Secs. 1-75).
2. Specific kinds of contracts, *viz.*:

(*a*) Contracts of Indemnity and Guarantee (Secs. 124-147).
(*b*) Contracts of Bailment and Pledge (Secs. 148-181).
(*c*) Contracts of Agency (Secs. 182-238).

Before 1930 the Act also contained provisions relating to contracts of sale of goods and partnership. Sections 76-123 relating to sale of goods were repealed in 1930 and a separate Act called the Sale of Goods Act was enacted. Similarly, Sections 239-266 relating to partnership were repealed in 1932 when the Indian Partnership Act was passed.

Basic assumptions underlying the Act. Before we take up the discussion of the various provisions of the Indian Contract Act, it will be proper to see some of the basic assumptions underlying the Act. These are:

1. Subject to certain limiting principles, there shall be freedom of contract to the contracting parties and the law shall enforce only what the parties have agreed to be bound. The law shall not lay down absolute rights and liabilities of the contracting parties. Instead it shall lay down only the essentials of a valid contract and the rights and obligations it would create between the parties in the absence of anything to the contrary agreed to by the parties.

2. Expectations created by promises of the parties shall be fulfilled and their non-fulfilment shall give rise to legal consequences. If the plaintiff asserts that the defendant undertook to do a certain act and failed to fulfil his promise, an action at law shall lie.

Definition of Contract

According to Section 2 (h) of the Indian Contract Act: "An agreement enforceable by law is a contract." A contract, therefore, is an agreement the object of which is to create a legal obligation *i.e.*, a duty enforceable by law.

From the above definition, we find that a contract essentially consists

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of two elements: (1) An agreement, and (2) Legal obligation *i.e.*, a duty enforceable by law. We shall now examine these elements in detail.

1. **Agreement.** As per Section 2(e): "Every promise and every set of promises, forming the consideration for each other, is an agreement." Thus it is clear from this definition that a 'promise' is an agreement. What is a 'promise'? The answer to this question is contained in Section 2(b) which defines the term:"When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. A proposal, when accepted, becomes a promise." An agreement, therefore, comes into existence only when one party makes a proposal or offer to the other party and that other party signifies his assent (*i.e.*, gives his acceptance) thereto. In short, an agreement is the sum total of 'offer' and 'acceptance'.

On analysing the above definition the following characteristics of an agreement become evident:

(a) Plurality of persons. There must be two or more persons to make an agreement because one person cannot enter into an agreement with himself.

(b) Consensus-ad-idem. Both the parties to an agreement must agree about the subject-matter of the agreement in the same sense and at the same time.

2. **Legal obligation.** As stated above, an agreement to become a contract must give rise to a legal obligation *i.e.*, a duty enforceable by law. If an agreement is incapable of creating a duty enforceable by law, it is not a contract. Thus an agreement is a *wider term* than a contract. "All contracts are agreements but all agreements are not contracts."Agreements of moral, religious or social nature *e.g.*, a promise to lunch together at a friend's house or to take a walk together are not contracts because they are not likely to create a duty enforceable by law for the simple reason that the parties never intended that they should be attended by legal consequences.

In business agreements the presumption is usually that the parties intend to create legal relations. Thus an agreement to buy certain specific goods at an agreed price *e.g.*, 100 bags of wheat at Rs 430 per bag is a contract because it gives rise to a duty enforceable by law, and in case of default on the part of either party an action for breach of contract could be enforced through a court provided other essential elements of a valid contract as laid down in Section 10 are present, namely, if the contract was made by free consent of the parties competent to contract, for a lawful consideration and with a lawful object.[2]

[2] For details refer to the next heading *Essential Elements of a Valid Contract.*

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Thus it may be concluded that the Act restricts the use of the word 'contract' to only those agreements which give rise to legal obligations between the parties.

It will be appropriate to point out here that the law of contract deals only with such legal obligations which spring from agreements. Obligations which are not contractual in nature are outside the purview of the law of contract. For example, obligation to maintain wife and children (status obligation), obligation to observe the laws of the land, and obligation to comply with the orders of a court of law do not fall within the scope of the Contract Act. Salmond has rightly observed: "The law of contracts is not the whole law of agreements, nor is it the whole law of obligations. It is the law of those agreements which create obligations, and those obligations, which have their source in agreements"

Essential Elements of a Valid Contract

A contract has been defined in Section 2(h) as "an agreement enforceable by law." To be enforceable by law, an agreement must possess the essential elements of a valid contract as contained in Sections 10, 29 and 56. According to Section 10, all agreements are contracts if they are made by the free consent of the parties, competent to contract, for a lawful consideration, with a lawful object, are not expressly declared by the Act to be void, and, where necessary, satisfy the requirements of any law as to writing or attestation or registration. As the details of these essentials form the subject-matter of our subsequent chapters, we propose to discuss them in brief here.

The essential elements of a valid contract are as follows:

1. **Offer and acceptance.** There must be a 'lawful offer' and a 'lawful acceptance' of the offer, thus resulting in an agreement. The adjective 'lawful' implies that the offer and acceptance must satisfy the requirements of the Contract Act in relation thereto.

2. **Intention to create legal relations.** There must be an intention among the parties that the agreement should be attached by legal consequences and create legal obligations. Agreements of a social or domestic nature do not contemplate legal relations, and as such they do not give rise to a contract. An agreement to dine at a friend's house is not an agreement intended to create legal relations and therefore is not a contract. Agreements between husband and wife also lack the intention to create legal relationship and thus do not result in contracts.

ILLUSTRATIONS. (*a*) *M* promises his wife *N* to get her a saree if she will sing a song. *N* sang the song but *M* did not bring the saree for her. *N* cannot bring an action in a Court to enforce the agreement as it lacked the intention to create legal relations.

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(*b*) The defendant was a civil servant stationed in Ceylon. He and his wife were enjoying leave in England. When the defendant was due to return to Ceylon, his wife could not accompany him because of her health. The defendant agreed to send her £ 30 a month as maintenance expenses during the time they were thus forced to live apart. She sued for breach of this agreement. Her action was dismissed on the ground that no legal relations had been contemplated and therefore there was no contract. (*Balfour* vs *Balfour*[3])

In commercial agreements an intention to create legal relations is presumed. Thus, an agreement to buy and sell goods intends to create legal relationship, hence is a contract, provided other requisites of a valid contract are present. But if the parties have expressly declared their resolve that the agreement is not to create legal obligation, even a business agreement does not amount to a contract. The case of *Rose & Frank Co.* vs *Crompton & Brothers Ltd.*,[4] provides a good illustration on the point.

ILLUSTRATION. In the above case *R* company entered into an agreement with *C* Company, by means of which the former was appointed as the agent of the latter. One clause of the agreement was as follows: "This arrangement is not entered into as a formal or legal agreement, and shall not be subject to legal jurisdiction in the law courts". It was held that there was no intention to create legal relations on the part of parties to the agreement and hence there was no contract.

3. **Lawful consideration.** The third essential element of a valid contract is the presence of 'consideration'. Consideration has been defined as the price paid by one party for the promise of the other. An agreement is legally enforceable only when each of the parties to it gives something and gets something. The something given or obtained is the price for the promise and is called 'consideration'. Subject to certain exceptions, gratuitous promises are not enforceable at law.

The 'consideration' may be an act (doing something) or forbearance (not doing something) or a promise to do or not to do something. It may be past, present or future. But only those considerations are valid which are 'lawful'. The consideration is 'lawful', unless—it is forbidden by law; or is of such a nature that, if permitted it would defeat the provisions of any law; or is fraudulent; or involves or implies injury to the person or property of another; or is immoral; or is opposed to public policy (Sec. 23).

4. **Capacity of parties.** The parties to an agreement must be competent to contract, otherwise it cannot be enforced by a court of law. In order to be competent to contract the parties must be of the age of majority and of sound mind and must not be disqualified from contracting by any law to which they are subject (Sec. 11). If any of the parties to the agreement suffers from minority, lunacy, idiocy, drunkenness, *etc.*, the agreement is

[3](1919),K.B. 571.
[4] (1923), 2 K.B. 261.

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not enforceable at law, except in some special cases *e.g.*, in the case of necessaries supplied to a minor or lunatic, the supplier of goods is entitled to be reimbursed from their estate (Sec.68).

5. **Free consent.** Free consent of all the parties to an agreement is another essential element of a valid contract.'Consent' means that the parties must have agreed upon the same thing in the same sense (Sec.13). There is absence of 'free consent', if the agreement is induced by (*i*) coercion, (*ii*) undue influence, (*iii*) fraud, (*iv*) mis-representation, or (*v*) mistake (Sec. 14). If the agreement is vitiated by any of the first four factors, the contract would be viodable and cannot be enforced by the party guilty of coercion, undue influence etc. The other party (*i.e.*, the aggrieved party) can either reject the contract or accept it, subject to the rules laid down in the Act. If the agreement is induced by mutual mistake which is material to the agreement, it would be void (Sec.20).

6. **Lawful object.** For the formation of a valid contract it is also necessary that the parties to an agreement must agree for a lawful object. The object for which the agreement has been entered into must not be fraudulent or illegal or immoral or opposed to public policy or must not imply injury to the person or property of another (Sec. 23). If the object is unlawful for one or the other of the reasons mentioned above the agreement is void. Thus, when a landlord knowingly lets a house to a prostitute to carry on prostitution, he cannot recover the rent through a court of law.

7. **Writing and registration.** According to the Indian Contract Act, a contract may be oral or in writing. But in certain special cases it lays down that the agreement, to be valid, must be in writing or/and registered. For example, it requires that an agreement to pay a time barred debt must be in writing and an agreement to make a gift for natural love and affection must be in writing and registered (Sec. 25). Similarly, certain other Acts also require writing or/and registration to make the agreement enforceable by law which must be observed. Thus, (*i*) an arbitration agreement must be in writing as per the Arbitration Act, 1940; (*ii*) an agreement for a sale of immovable property must be in writing and registered under the Transfer of Property Act, 1882 before they can be legally enforced.

8. **Certainty.** Section 29 of the Contract Act provides that "Agreements, the meaning of which is not certain or capable of being made certain, are void." In order to give rise to a valid contract the terms of the agreement must not be vague or uncertain. It must be possible to ascertain the meaning of the agreement, for otherwise, it cannot be enforced.

ILLUSTRATION. *A*, agrees to sell *B* "a hundred tons of oil." There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty.

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9. **Possibility of performance.** Yet another essential feature of a valid contract is that it must be capable of performance. Section 56 lays down that "An agreement to do an act impossible in itself is void". If the act is impossible in itself, physically or legally, the agreement cannot be enforced at law.

ILLUSTRATION. A, agrees with B, to discover treasure by magic. The agreement is not enforceable.

10. **Not expressly declared void.** The agreement must not have been expressly declared to be void under the Act. Sections 24-30 specify certain types of agreements which have been expressly declared to be void. For example, an agreement in restraint of marriage, an agreement in restraint of trade, and an agreement by way of wager have been expressly declared void under Sections 26, 27 and 30 respectively.

Before dealing with the various essentials of a valid contract one by one in detail, it will be appropriate to discuss the 'kinds of contracts', first, because we shall be using the terms like 'voidable contract', 'void contract', 'void agreement', *etc.*, very often in the course of our discussion.

KINDS OF CONTRACTS

Kinds of Contracts from the Point of View of Enforceability

From the point of view of enforceability a contract may be *valid* or *voidable* or *void* or *unenforceable* or *illegal.*

1. Valid contract. A valid contract is an agreement enforceable by law. An agreement becomes enforceable by law when all the essential elements of a valid contract as enumerated above are present.

2. **Voidable contract.** According to Section 2(i), "an agreement which is enforceable by law at the option of one or more of the parties thereto, but not at the option of the other or others, is a voidable contract." Thus, a voidable contract is one which is enforceable by law at the option of one of the parties. Until it is avoided or rescinded by the party entitled tc do so by exercising his option in that behalf, it is a valid contract.

Usually a contract becomes voidable when the consent of one of the parties to the contract is obtained by coercion, undue influence, misrepresentation or fraud. Such a contract is voidable at the option of the aggrieved party *i.e.*, the party whose consent was so caused (Secs. 19 and 19A). But the aggrieved party must exercise his option of rejecting the contract (*i*) within a reasonable time, and (*ii*) before the rights of third parties intervene, otherwise the contract cannot be repudiated.

ILLUSTRATIONS. (*a*) *A*, threatens to shoot *B* if he does not sell his new Bajaj scooter to *A* for Rs 2,000. *B* agrees. The contract has been brought about by coercion and is voidable at the option of *B*.

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(*b*) *A*, intending to deceive *B*, falsely represents that five hundred quintals of indigo are made annually at *A*'s factory, and thereby induces *B* to buy the factory. The contract has been caused by fraud and is voidable at the option of *B*.

Other circumstances under which a contract becomes voidable. The Indian Contract Act has laid down certain other situations also under which a contract becomes voidable. For example,

(*i*) When a contract contains reciprocal promises, and one party to the contract prevents the other from performing his promise, then the contract becomes voidable at the option of the party so prevented (Sec. 53).

ILLUSTRATION. *A*, contracts with *B* that *A* shall whitewash *B*'s house for Rs. 100. *A*, is ready and willing to execute the work accordingly, but *B* prevents him from doing so. The contract becomes voidable at the option of *A*.

(*ii*) When a party to the contract promises to do a certain thing within a specified time, but fails to do it, then the contract becomes voidable at the option of the promisee, if the intention of the parties was that time should be of the essence of the contract (Sec.55).

ILLUSTRATION. *X*, agrees to sell and deliver 10 bags of wheat to *Y* for Rs.2,500 within one week. But *X* does not supply the wheat within the specified time. The contract becomes voidable at the option of *Y*.

Consequences of rescission of voidable contract. Section 64 lays down the rights and obligations of the parties to a voidable contract after it is rescinded. The Section states that when a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is a promisor. If the party rescinding a voidable contract has received any benefit from another party to such contract, he must restore such benefit, so far as may be, to the person from whom it was received. For example, when a contract for the sale of a house is avoided on the ground of undue influence, any money received on account of the price must be refunded. Notice that the Section aims at placing both the parties to a voidable contract, after its rescission, on the same footing as for there had been no contract at all. But it must be remembered that the benefit which is to be restored must have been received under the contract. If an amount has been received has a security for the due performance of the contract, such earnest money deposit is not to be returned if the contract becomes voidable under Section 55 on account of the promisor's failure to complete the contract at the time agreed and has been rescinded by the promisee because it is not a benefit received under the contract.

3. **Void contract.** Literally the word 'void' means 'not binding in law'. Accordingly the term 'void contract' implies a useless contract which has no legal effect at all. Such a contract is a nullity, as for there has been no contract at all. Section 2(j) defines: "A contract which ceases to be enforceable by law becomes void, when it ceases to be enforceable." It follows

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from the definition that a void contract is not void from its inception and that it is valid and binding on the parties when originally entered but subsequent to its formation it becomes invalid and destitute of legal effect because of certain reasons.

The reasons which transform a valid contract into a void contract, as given in the Contract Act, are as follows:

(a) Supervening impossibility (Sec. 56).[5] A contract becomes void by impossibility of performance after the formation of the contract. For example, *A* and *B* contract to marry each other. Before the time fixed for the marriage, *A* goes mad. The contract to marry becomes void.

(b) Subsequent illegality (Sec. 56).[5] *A* contract also becomes void by subsequent illegality. For example, *A* agrees to sell *B* 100 bags of wheat at Rs. 650 per bag. Before delivery, the Government bans private trading in wheat. The contract becomes void.

(c) Repudiation of a voidable contract. A voidable contract becomes void, when the party, whose consent is not free, repudiates the contract. For example, *M* by threatening to murder *B*'s son, makes *B* agree to sell his car worth Rs 30,000 for a sum of Rs 10,000 only. The contract, being the result of coercion, is voidable at the option of *B*. *B* may either affirm or reject the contract. In case *B* decides to rescind the contract, it becomes void.

(d) In the case of a contract contingent on the happening of an uncertain future event, if that event becomes impossible. A contingent contract to do or not to do something on the happening of an uncertain future event, becomes void, when the event becomes impossible (Sec. 32).[6] For example, *A* contracts to give Rs 1,000 as loan to *B*, if *B* marries *C*. *C* dies without being married to *B*. The contract becomes void.

Void agreement. "An agreement not enforceable by law is said to be void" [Sec.2 (g)]. Thus, a void agreement does not give rise to any legal consequences and is void *ab-initio*. In the eye of law such an agreement is no agreement at all from its very inception. There is absence of one or more essential elements of a valid contract, except that of 'free consent,' in the case of a void agreement. Thus, an agreement with a minor is void *ab-initio* as against him, because a minor lacks the capacity to contract. Similarly, an agreement without consideration is void *ab-initio,* of course with certain exceptions as laid down in Section 25. Certain agreements have been expressly declared void in the Contract Act *e.g.*, agreements which are in restraint of trade or of marriage or of legal proceedings or which are by way of wager.[7]

[5] It has been discussed in detail later in the Chapter on *Discharge of Contract.*
[6] For details refer to the Chapter on *Contingent Contracts.*
[7] Refer to the Chapter on *Void Agreements* for details.

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A 'void agreement' should be distinguished from a 'void contract'. A 'void agreement' never amounts to a contract as it is void *ab-initio*. A 'void contract' is valid when it is entered into, but subsequent to its formation something happens which makes it unenforceable by law. Notice that a contract cannot be void *ab-initio* and only an agreement can be void *ab-initio*.

Obligation of person who has received advantage under void agreement or contract that becomes void. In this connection Section 65 lays down that when an agreement is discovered to be void or when a contract becomes void, any person who has received any advantage under such agreement or contract is bound to *restore* it, or to *make compensation* for it, to the person from whom he received it. Thus, this Section provides for *restitution* of the benefit received; so that both parties may stand uneffected by the transaction; in the following two cases:

(a) When an agreement is discovered to be void. In other words, when an agreement is void *ab-initio* but the fact of its being void being discovered at a later stage. For example, *A* pays *B* Rs. 1,000 for *B*'s agreeing to sell his horse to him. It turns out that the horse was dead at the time of the bargain, though neither party was aware of the fact. In this case the agreement is discovered to be void and *B* must repay to *A* Rs 1,000. It should, however, be noted that agreements which are *known* to be void or illegal, when they are entered into, are excluded from the purview of this Section. Thus, if *L* pays Rs 10, 000 to *M* to murder *Z*, the money cannot be recovered. Similarly, nothing can be recovered in the case of expressly declared void agreements, of course, subject to the following exceptions:

(*i*) in the case of an agreement caused by bilateral mistake of essential fact (although it is expressly declared void under Section 20) restitution is allowed as it comes under the category of 'an agreement discovered to be void'.

(*ii*) in the case of an agreement with a minor who commits fraud by misrepresenting his age (although agreement with a minor is known to be void) restoration is allowed in specie on equitable grounds because a minor cannot be allowed to cheat people, and also because the other party has not lost his title to the thing in question.

(*b*) *When a contract becomes void.* Restitution is also allowed in the case of a void contract. For example, *A* agrees to sell *B* after one month 10 quintals of wheat at Rs 625 per quintal and receives Rs. 500 as advance. Soon after the contract, private sales of wheat are prohibited by an Act of the legislature. The contract becomes void but *A* must return the sum of Rs. 500 to *B*. Similarly, where after accepting Rs 1,000 as advance for singing at a concert for *B*, *A* is too ill to sing. *A* is not bound to make

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compensation to *B* for the loss of the profits which *B* would have made if A would have been able to sing, but A must refund to *B* the 1,000 rupees paid in advance.

4. **Unenforceable contract.** An unenforceable contract is one which is valid in itself, but is not capable of being enforced in a court of law because of some technical defect such as absence of writing, registration, requisite stamp, *etc.*, or time barred by the law of limitation. For example, an oral arbitration agreement is unenforceable because the law requires an arbitration agreement to be in writing. Similarly, a bill of exchange or promissory note, though valid in itself, becomes unenforceable after three years from the date the bill or note falls due, being time barred under the Limitation Act.

5. **Illegal or unlawful contract.** The word 'illegal' means 'contrary to law' and the term 'contract' means 'an agreement enforceable by law.' As such to speak of an 'illegal contract' involves a contradiction in terms, because it means something like this—an agreement enforceable by law and contrary to law. There is apparent contradiction in terms. Moreover, being of unlawful nature, such an agreement can never attain the status of a contract. Thus, it will be proper if we use the term 'illegal agreement' in place of 'illegal contract'. An illegal agreement is void *ab-initio.*

An agreement is illegal and void if its object or consideration: (*a*) is forbidden by law; or (*b*) is of such a nature that, if permitted, it would defeat the provisions of any law; or (*c*) is fraudulent; or (*d*) involves or implies injury to the person or property of another; or (e) the court regards it as immoral, or opposed to public policy (Sec.23).[8] Thus, an agreement to commit murder or assault or robbery or to make a gift in consideration of illicit intercourse would be illegal and void *ab-initio.*

Illegal and void agreements distinguished. Despite the similarity between an illegal and a void agreement that in either case the agreement is void *ab-initio* and cannot be enforced by law, the two differ from each other in the following two respects:

(*i*) An illegal agreement is narrower in scope than a void agreement. 'All illegal agreements are void but all void agreements are not necessarily illegal.' The object or consideration of an agreement may not be contrary to law but may still be void. For example, an agreement with a minor is void as against him but not illegal. Again, an agreement the terms of which are uncertain is void but such an agreement is not illegal.

(*ii*) An illegal agreement is wider in effect in relation to collateral transactions than a void agreement. When an agreement is illegal, other

[8] For details refer to the Chapter on *Legality of Object and Consideration.*

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agreements which are incidental or collateral to it are also tainted with illegality, hence void, provided the third parties have the knowledge of the illegal or immoral design of the main transaction. The reason underlying this rule is that no person shall be allowed to invoke the aid of the court if he is himself implicated in the illegality. On the other hand, when an agreement is void (but not illegal), agreements which are collateral to it are not invalidated and remain valid.

ILLUSTRATIONS. (*a*) *A* engages *B* to murder *C* and borrows Rs 5,000 from *D* to pay *B*. *D* is aware of the purpose of the loan. Here the agreement between *A* and *B* is illegal and the agreement between *A* and *D* is collateral to an illegal agreement. As such the loan transaction is illegal and void and *D* cannot recover the money. But the position will change if *D* is not aware of the purpose of the loan. In that case the loan transaction is not collateral to the illegal agreement and is a valid contract.

(*b*) In the above case if *A* borrows from *D* to pay his wagering debts (a wagering agreement is void under Section 30), the contract between *A* and *D* would not have been affected, even though *D* is aware of the purpose of the loan because an agreement collateral to a void agreement is perfectly valid.

Kinds of Contracts from the Point of View of Mode of Creation

From the point of view of mode of creation a contract may be *express* or *implied* or *constructive*.

1. **Express contract.** Where both the offer and acceptance constituting an agreement enforceable at law are made in words spoken or written, it is an express contract. For example, *A* tells *B* on telephone that he offers to sell his car for Rs 20, 000 and *B* in reply informs *A* that he accepts the offer, there is an express contract.

2. **Implied contract.** Where both the offer and acceptance constituting an agreement enforceable at law are made otherwise than in words *i.e.*, by acts and conduct of the parties, it is an implied contract. Thus, where *A*, a coolie in uniform takes up the luggage of *B* to be carried out of the Railway station without being asked by *B*, and *B* allows him to do so, then the law implies that *B* agrees to pay for the services of *A*, and there is an implied contract. Similarly, where *M*, a professional shoe shiner starts polishing the shoes of *N* without being requested to do so, and *N* allows *M* to polish his shoes knowing that *M* expects to be paid for the service, there comes into existence an implied contract and *N* is under obligation to pay to *M*.

It is relevant to state that in respect of mode of creation, certain contracts may be a mixture of the 'express' and 'implied' types of contracts, that is, where out of the two components of an agreement, namely, offer and acceptance, one is expressed in words and the other is implied from

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acts and circumstances. Such contracts may be called as *contracts of mixed character*. For example, *A* offers to buy *B*'s scooter for Rs 4,000 and *B* accepts the offer by sending the scooter itself. Here *A*'s offer is expressed in words and *B*'s acceptance is implied from his conduct. It is a contract of mixed character.

3. **Constructive or quasi contract.** The term 'constructive or quasi contract' is a misnomer. The cases grouped under this type of contracts have little or no affinity with contract. Such a contract does not arise by virtue of any agreement, express or implied between the parties but the law infers or recognises a contract under certain special circumstances. For example, obligation of finder of lost goods to return them to the true owner or liability of person to whom money is paid under mistake to repay it back cannot be said to arise out of a contract even in its remotest sense, as there is neither offer and acceptance nor consent, but these are very much covered under quasi contracts as per Sections 71 and 72 respectively. The Contract Act has rightly named such contracts as "certain relations resembling those created by contract".

A quasi contract is based upon the equitable principle that a person shall not be allowed to retain unjust benefit at the expense of another. Sections 68-72 of the Contract Act describe the cases which are to be deemed 'quasi contracts'.[9]

Kinds of Contracts from the Point of View of the Extent of Execution

From the point of view of the extent of execution a contract may be *executed* or *executory*.

1. **Executed contract.** A contract is said to be executed when both the parties to a contract have completely performed their share of obligation and nothing remains to be done by either party under the contract. For example, when a bookseller sells a book on cash payment it is an executed contract because both the parties have done what they were to do under the contract.

Where only one of the parties to a contract has performed his share of obligation and the other party is still to perform his share of obligation, then also the contract is called 'executed'. For example, *M* advertises a reward of Rs 1,000 to anyone who finds his missing son. *B* knowing the offer finds the missing boy and brings him. As soon as *B* traces the boy, there comes into existence an executed contract because *B* has performed his share of obligation and it remains for *M* to pay the amount of reward to *B*. This type of executed contracts are also called *Unilateral Contracts* because in such

[9] These cases have been discussed in detail in the Chapter on *Quasi Contracts*.

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contracts only one obligation remains outstanding, the other obligation having being performed at the time of or *before* the formation of the contract.

2. **Executory contract.** It is one in which both the obligations are outstanding, one on either party to the contract, either wholly or in part, at the time of the formation of the contract. In other words, a contract is said to be executory when either both the parties to a contract have still to perform their share of obligation in toto or there remains something to be done under the contract on both sides. For example, where *T* agrees to coach R, a pre-medical student, from first day of the next month and *R* in consideration promises to pay *T* Rs 500 per month, the contract is executory because it is yet to be carried out. Similarly, where *M* promises to sell his car to *N* for Rs 10,000 cash down, but *N* pays only Rs 1,000 as earnest money and promises to pay the balance on next Sunday. On the other hand, *M* gives the possession of car to *N* and promises to execute a sale deed on receipt of the full amount. The contract between *M* and *N* is executory because there remains something to be done on both sides. Executory contracts are also known as *Bilateral Contracts.*

TEST QUESTIONS

1. "An agreement enforceable by law is a contract." Discuss the definition and bring out clearly the essentials of a valid contract.
2. "All contracts are agreements, but all agreements are not contracts." Discuss the statement explaining the essential elements of a valid contract.
3. "The law of contracts is not the whole law of agreements, nor is it the whole law of obligations" (Salmond). Comment.
4. Discuss the essential elements of a valid contract.
5. What do you understand by the terms 'void' and 'voidable' contracts? Discuss the rights and obligations of the parties to a void contract and to a voidable contract after its rescission.
6. Distinguish between:
   (*a*) Void and Voidable contracts.
   (*b*) Void agreements and Void contracts.
   (*c*) Void and Illegal agreements.
7. Write short notes on:
   (*a*) Implied contract, (*b*) Quasi contract, (*c*) Executed contract, and
   (*d*) Bilateral contract.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* invites *B* to a dinner. *B* accepts the invitation. A made elaborate arrange-

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ment but *B* failed to turn up. Can *A* sue *B* for the loss he has suffered?

[**Hint**. No, *A* cannot sue *B* for the loss he has suffered because the agreement was of a social nature and hence lacked the intention to create legal relationship — one of the essentials of a valid contract.]

2. *M* agrees to pay *N* Rs 100 and in consideration *N* agrees to write for him 100 pages within five minutes. Is it a valid contract?

[**Hint.** No, it is not a valid contract. It is a void agreement because as per Section 56 "an agreement to do an act impossible in itself is void."]

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Chapter 2

Offer and Acceptance

While discussing the essential elements of a valid contract in the preceding chapter we observed that as a first step in the making of a contract there must be a 'lawful offer' by one party and a 'lawful acceptance' of the offer by the other party. Thus where *A*, offers to sell a wrist watch to *B* for Rs. 200 and *B* accepts the offer, a contract comes into being provided other essentials of a valid contract like that of competency of parties to contract, *etc.*, are present. We propose to discuss in this chapter the legal rules relating to a 'lawful offer' and a 'lawful acceptance'

THE PROPOSAL OR OFFER

The words 'proposal' and 'offer' are synonymous and are used interchangeably. Section 2(a) of the Indian Contract Act defines a 'proposal' as, "when one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal". This definition reveals the following three essentials of a 'proposal':

(*i*) It must be an *expression of the willingness* to do or to abstain from doing something.

(*ii*) The expression of willingness to do or to abstain from doing something must be *to another person.* There can be no 'proposal' by a person to himself.

(*iii*) The expression of willingness to do or to abstain from doing something must be made *with a view to obtaining the assent of the other person* to such act or abstinence. Thus a casual enquiry — "Do you intend to sell your motorcycle?" — is not a 'proposal'. Similarly, a mere statement of intention — "I may sell my motorcycle if I can get Rs 4,000 for it" — is not a 'proposal'. But if *M* says to *N*, "Will you buy my motorcycle for Rs 4,000," *or* "I am willing to sell my motorcycle to you for Rs 4,000," we have a 'proposal' as it has been made with the object of obtaining the assent of *N*.

The person making the 'proposal' or 'offer' is called the 'promisor' or

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'offeror', the person to whom the offer is made is called the 'offeree,' and the person accepting the offer is called the 'promisee' or 'acceptor'.

Legal Rules Regarding a Valid Offer

A valid offer must be in conformity with the following rules:

1. **An offer may be 'express' or 'implied'.** An offer may be made *either* by words *or* by conduct. An offer which is expressed by words, spoken or written, is called an 'express offer' and the one which is inferred from the conduct of a person or the circumstances of the case is called an 'implied offer'.

ILLUSTRATIONS. (*a*) *M* says to *N* that he will sell his motorcycle to him for Rs 4,000. This is an express offer.

(*b*) *X* writes to *Y* that he offers to sell his house to him for Rs 80,000. There is an express offer.

(*c*) The Delhi Transport Corporation runs omnibuses on different routes to carry passengers at the scheduled fares. This is an implied offer by the D.T.C.

(*d*) A shoe shiner starts shining some one's shoes, without being asked to do so, in such circumstances that any reasonable man could guess that he expects to be paid for this, he makes an implied offer.

2. **An offer must contemplate to give rise to legal consequences and be capable of creating legal relations.** If the offer does not intend to give rise to legal consequences, it is not a valid offer in the eye of law. An offer to a friend to dine at the offeror's place, or an offer to one's wife to show her a movie is not a valid offer and as such cannot give rise to a binding agreement, even though it is accepted and there is consideration, because in social agreements or domestic arrangements the presumption is that the parties do not intend legal consequences to follow the breach of agreement. But in the case of agreements regulating business transactions the presumption is just the other way. In business agreements it is taken for granted that parties intend legal consequences to follow. Even in the case of a business agreement if the parties agree that the breach of the agreement would not confer on either of the parties a right to enforce the agreement in a court of law, there is no contract (*Rose & Frank Co.* vs *Crompton & Brothers Ltd.*[1]).

3. **The terms of the offer must be certain and not loose or vague.** If the terms of the offer are not definite and certain, it does not amount to a lawful offer. Maugham L.J. has rightly observed: "Unless all the material terms of the contract are agreed, there is no binding obligation." Thus an agreement to agree in future is not a contract, because the terms of agreement are uncertain as they are yet to be settled.

ILLUSTRATIONS. (*a*) *X* purchased a horse from *Y* and promised to buy

[1](1923), 2 K.B. 261.

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another, if the first one proves lucky. *X* refused to buy the second horse. *Y* could not enforce the agreement it being loose and vague (*Taylor* vs *Portington*).[2]

(*b*) *A* offers to *B* lavish entertainment, if *B* does a particular work for him. *A*'s offer does not amount to lawful offer being vague and uncertain.

4. **An invitation to offer is not an offer.** An offer must be distinguished from an 'invitation to receive offer' or as it is sometimes expressed in judicial language an 'invitation to treat.' In the case of an 'invitation to receive offer' the person sending out the invitation does not make an offer but only invites the other party to make an offer. His object is merely to circulate information that he is willing to deal with anybody who, on such information, is willing to open negotiations with him. Such invitations for offers are therefore not offers in the eye of law and do not become agreements by their acceptance. We may give some examples of them here:

(*a*) An advertisement for sale of goods by auction does not amount to an offer to hold such sale. It merely invites offers. Actual bids made at the auction are 'offers', each higher bid superseding the previous one, and when the hammer falls on the highest bid, there is an acceptance and the contract becomes complete. An advertisement for an auction sale does not even bind the auctioneer to hold the auction and the prospective bidders have no legal right to complaint if they have wasted their time and money in coming to the advertised place of the auction sale (*Harris* vs *Nickerson*[3]).

(*b*) Quotations, catalogues of prices or display of goods with prices marked thereon do not constitute an offer. They are instead an invitation for offer and hence if a customer asks for goods or makes an offer, the shopkeeper is free to accept the offer or not. While explaining the logic behind the aforesaid rule, Lord Herschell has made an interesting observation in *Grainger & Son* vs *Gough*[4]: "The transmission of such a price-list does not amount to an offer to supply an unlimited quantity of the wine described at the price named, so that as soon as an order is given there is a binding contract to supply that quantity. If it were so, the merchant might find himself involved in any number of contractual obligations to supply wine of a particular description which he would be quite unable to carry out, his stock of wine of that description being necessarily limited."

ILLUSTRATION. There is a 'self service system' in a shop. A customer selects the goods and takes them to the cashier for payment of the price. The cashier totals the price and accepts the amount. The contract, in this case is made, not when the customer selects the goods, but when the cashier accepts the offer by accepting the payment. The selection of goods by the customer constitutes an 'implied offer' to buy goods and the acceptance of payment by the cashier consti-

[2](1855), 44 E.R. 128.
[3](1873), L.R. 8 Q.B. 286.
[4](1896),A.C. 325.

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tutes 'acceptance' of the offer. [*Pharmaceutical Society of Great Britain* vs *Boots Cash Chemists (Southern), Ltd.*][5]

(*c*) A notice that goods will be sold by 'tender' does not amount to an offer. It is only an attempt to ascertain whether an offer can be obtained within such a margin as the seller is willing to adopt (*Spencer* vs *Harding*)[6]. The tenderers by submitting their tenders make offers and it is for the party inviting tenders to accept them or not.

5. **An offer may be 'specific' or 'general'.** An offer is said to be 'specific' when it is made to a definite person or persons. Such an offer can be accepted only by the person or persons to whom it is made. Thus, where *M* makes an offer to *N* to sell his bicycle for Rs 200, there is a specific offer and *N* alone can accept it. A 'general offer', on the other hand, is one which is made to the world at large or public in general and may be accepted by any person who fulfils the requisite conditions. The leading case on the subject of 'general offer' is that of *Carlill* vs *Carbolic Smoke Ball Co.*[7]

ILLUSTRATION. In the above case the Carbolic Smoke Ball Co., issued an advertisement in which the Company offered to pay £ 100 to any person who contracts influenza, after having used their Smoke Balls three times daily for two weeks, according to the printed directions. Mrs Carlill, on the faith of the advertisement, bought and used the Balls according to the directions, but she nevertheless subsequently suffered from influenza. She sued the company for the promised reward. The company was held liable.

Offers of reward made by way of advertisement, addressed to the public at large, for the rendering of certain services, or the restoration of lost article are also examples of general offers. Such offers may be accepted by performance of the conditions by an individual person in order to give rise to a contractual obligation to pay the reward. It is worth noting that there cannot be a contract with the public at large and as such a general offer cannot result into a contract until it has been accepted by an ascertained person. If a large number of persons accepted a general offer, there would be an equal number of separate contracts. Again, it is only the general offers of continuing nature, as it was in the Smoke Ball Company case discussed above, which can be accepted by a number of persons. In case of general offer of reward for some information or restoration of a missing thing, the offer is open for acceptance to only one individual who performs the required condition first of all, and as soon as the condition is first performed the offer is closed.

6. **An offer must be communicated to the offeree.** An offer is effective only when it is communicated to the offeree. Until the offer is made

[5](1952), 2 All. E.R. 456.
[6](1870), L.R.5 C.P.561.
[7](1893), 1 Q.B. 256.

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known to the offeree, there can be no acceptance and no contract. Doing anything in ignorance of the offer can never be treated as its acceptance, for, there was never a *consensus* of wills. This applies to both 'specific' and 'general' offers.

ILLUSTRATIONS. (*a*) *A*, without knowing that a reward has been offered for the arrest of a particular criminal, catches the criminal and gives the information to the superintendent of police. *A*, cannot recover the reward as he cannot be said to have accepted the offer when he was not at all aware of it.

(*b*) In *Lalman Shukla* vs *Gauri Datt,*[8] the defendant's nephew absconded from home. He sent his servant, the plaintiff, in search of the boy. After the servant had left, the defendant announced a reward of Rs 501 to anybody giving information relating to the boy. The servant, before seeing the announcement, had traced the boy and informed the defendant. Later, on reading the notice of reward, the servant claimed it. His suit was dismissed on the ground that he could not accept the offer, unless he had knowledge of it.

Communication of special terms. Regarding the communication of the special terms of the contract as contained in a ticket, receipt, or 'standard form documents', the more important rules adopted by the courts are as follows:

(*i*) If the acceptor or the promisee had no knowledge of special terms, before or at the time of the contract, they are not binding upon the acceptor.

ILLUSTRATION. In *Handerson* vs *Stevenson,*[9] the plaintiff bought a steamer ticket which bore on its face the words: 'Dublin to Whitehaven.' On the back of the ticket certain special terms were printed one of which excluded the liability of the company for loss, injury or delay to the passenger or his luggage. The plaintiff never looked at the back of the ticket and no one told him to do so, and the front of the ticket bore no reference to the back. The plaintiff's luggage was lost in the ship-wreck caused by the fault of the company's servants. He claimed damages for its loss. It was held that the plaintiff was entitled to recover his loss from the company as there was not sufficient communication of the terms and conditions contained on the back of the ticket.

(*ii*) If the acceptor or the promisee had the knowledge or may be presumed to have the knowledge; because a reasonably sufficient notice has been given to him by suitable words on the document; of special terms, before or at the time of the contract, the terms are binding upon the acceptor whether he has read them or not is immaterial. The leading case on the point is *Parker* vs *South Eastern Railway Co.*[10]

ILLUSTRATION. In the above case *P* deposited his bag at the cloak-room at a railway station and received a ticket containing on its face the words, "*see back*'. On the back of the ticket there was a condition that, "the company will not be responsible for any package exceeding the value of £ 10 unless extra charge was

[8](1913), 11 All. L.J. 389.
[9](1875), 32 L.T. 709.
[10](1877), 2 C.P.D. 416.

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paid". A notice to the same effect was hung up in the cloak-room. P's bag was lost and he claimed the actual value of the lost bag, £ 24 Sh. 10. *P*, admitted knowledge of the printed matter on the ticket, but denied having read it. It was held that, even though he had not read the exemption clause, he was bound by it, as the defendants had done what was reasonably sufficient to give him notice of its existence, and therefore *P* was entitled to recover only £ 10.

Again, where the terms are printed in a language which the acceptor does not understand, he cannot set up this fact as a reason for not being bound by the terms, provided his attention is drawn to them by suitable words on the document. It is the acceptor's duty to ask for a translation of the terms before he actually accepts the offer and if he did not ask, he must suffer for his ignorance (*MacKillican* vs *The Compagnie Marikcmas de France*[11]). Similarly, the acceptor cannot plead that he was illiterate or blind, provided the notice is reasonably sufficient for the class of persons to which he belongs (*Thompson* vs *L.M. & S. Railway Co.*[12]).

It is important to note that the special terms and conditions become binding as part of the contract only if they are brought to the notice of the acceptor *before or at the time of contract.* A subsequent communication will not bind the contracting party unless he has assented thereto. The facts of *Olley* vs *Marlborough Court Ltd.*[13] case provide a good illustration on the point.

ILLUSTRATION. In the above case Olley and her husband hired a room at a hotel and paid for a week's board and lodging in advance. When they went to occupy the room there was a notice on one of the walls which contained the clause: 'The proprietors will not hold themselves responsible for articles lost or stolen, unless handed to the manageress for safe custody'. Owing to the negligence of the hotel staff, a thief entered the room and stole some of their property. The owner of the hotel was held liable since the notice formed no part of the contract as it came to the knowledge of the plaintiff after the contract had been entered into.

Finally, we must note that even where adequate notice of the terms and conditions in a document has been given, the *doctrine of fundamental breach and strict construction* protects the contracting party from the unreasonable consequences of wide and sweeping exemption clauses. Thus a dry-cleaner's terms that he will pay only eight times the amount of cleaning charges, for any damage to or loss of garments has been held to be unreasonable (*M. Siddalingappa* vs *T. Nataraj*).[14]

7. **An offer should not contain a term the non-compliance of which would amount to acceptance.** Thus an offeror cannot say that if acceptance is not communicated up to a certain date, the offer would be presumed to

[11](1880), 6 Cal. 227.
[12](1930), 1 K.B. 41.
[13](1949), 1 K.B. 532.
[14](1970), A.I.R. Mys. 154.

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have been accepted. If the offeree does not reply, there is no contract, because no obligation to reply can be imposed on him, on the grounds of justice.

8. **An offer can be made subject to any terms and conditions.** An offeror may attach any terms and conditions to the offer he makes. He may even prescribe the mode of acceptance. The offeree will have to accept all the terms of the offer. There is no contract, unless all the terms of the offer are complied with and accepted in the mode prescribed. As regards mode of acceptance, it must be noted that in case of deviated acceptance, for example, if the offeror asks for sending the acceptance 'by telegram' and the offeree sends the acceptance 'by post', the offeror may decline to treat that acceptance as valid acceptance provided he gives a notice to that effect to the offeree within a reasonable time after the acceptance is communicated to him. If he does not inform the offeree as to this effect, he is deemed to have accepted the deviated acceptance (Sec.7).

9. **Two identical cross-offers do not make a contract.** When two parties make identical offers to each other, in ignorance of each other's offer, the offers are 'cross-offers'. 'Cross-offers' do not constitute acceptance of one's offer by the other and as such there is no completed agreement.

ILLUSTRATION. On 15 October, 1989 *A* wrote to *B* offering to sell him 100 tons of iron at Rs 8,800 per ton. On the same day, *B* wrote to *A* offering to buy 100 tons of iron at Rs 8,800 per ton. The letters crossed in the post. There is no concluded contract between *A* and *B*, because the offers were simultaneous, each being made in ignorance of the other, and there is no acceptance of each other's offer.

Lapse and Revocation of Offer

An offer lapses and becomes invalid (*i.e.*, comes to an end) in the following circumstances:

1. **An offer lapses after stipulated or reasonable time.** An offer lapses if acceptance is not communicated within the time prescribed in the offer, or if no time is prescribed, within a reasonable time [Sec. 6 (2)]. What is a reasonable time is a question of fact depending upon the circumstances of each case. For example, an offer made by telegram suggests that a reply is required urgently and if the offeree delays the communication of his acceptance even by a day or two, the offer will be considered to have lapsed.

ILLUSTRATION. In *Ramsgate Victoria Hotel Co.* vs *Montefiore*,[15] an application for allotment of shares was made on 8 June. The applicant was informed on the 23 November that shares were allotted to him. He refused to accept them. It was held that his offer had lapsed by reason of the delay of the company in notifying their acceptance, and that he was not bound to accept the shares.

[15](1866) L.R. 1 Ex. 109.

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2. **An offer lapses by not being accepted in the mode prescribed, or if no mode is prescribed, in some usual and reasonable manner.** But, according to Section 7, if the offeree does not accept the offer according to the mode prescribed, the offer does not lapse automatically. It is for the offeror to insist that his proposal shall be accepted only in the prescribed manner, and if he fails to do so he is deemed to have accepted the acceptance.

3. **An offer lapses by rejection.** An offer lapses if it has been rejected by the offeree. The rejection may be express *i.e.*, by words spoken or written, *or* implied. Implied rejection is one: (*a*) where either the offeree makes a *counter offer, or (b)* where the offeree gives a *conditional acceptance.*

ILLUSTRATIONS. (*i*) *A* offered to sell his house to *B* for Rs 90,000. *B* offered Rs 80,000 for which price *A* refused to sell. Subsequently *B* offered to purchase the house for Rs 90,000. *A*, declined to adhere to his original offer. *B* filed a suit to obtain specific performance of the alleged contract. Dismissing the suit, the court held that *A* was justified because no contract had come into existence, as *B*, by offering Rs 80,000, had rejected the original offer. Subsequent willingness to pay Rs 90,000 could be no acceptance of *A*'s offer as there was no offer to accept. The original offer had already come to an end on account of 'counter offer' (*Hyde* vs *Wrench*).[16]

(*ii*) *A*, offered to sell his motorcar to *B* for Rs 25,000. *B* said that he accepted the offer if he was appointed as General Manager of *A*'s factory. *B*'s acceptance is a 'conditional acceptance' which amounts to rejection of *A*'s offer and there is no contract.

It is worth noting that a rejection is effective only when it comes to the knowledge of the offeror. For example, *C* makes an offer to *D* by letter. Immediately on receiving the letter *D* writes a letter rejecting the offer. Before the rejection reaches *C*, *D* changes his mind and telephones his acceptance. There would be a contract between *C* and *D* and the rejection shall not be effective.

4. **An offer lapses by the death or insanity of the offeror or the offeree before acceptance.** If the offeror dies or becomes insane before acceptance, the offer lapses provided that the fact of his death or insanity comes to the knowledge of the acceptor before acceptance [Sec. 6 (4)]. From the language of the Section, it may be inferred that an acceptance in ignorance of the death or insanity of the offeror, is a valid acceptance, and gives rise to a contract. Thus the fact of death or insanity of the offeror would not put an end to the offer until it comes to the notice of the acceptor before acceptance. An offeree's death or insanity before accepting the offer puts an end to the offer and his heirs cannot accept for him (*Reynolds* vs *Atherton*).[17]

[16](1840), 3 Beav. 334.
[17](1921), 125 L.T. 690.

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5. **An offer lapses by revocation.** An offer is revoked when it is retracted back by the offeror. An offer may be revoked, at any time before acceptance, by the communication of notice of revocation by the offeror to the other party [Sec.6 (1)]. For example, at an auction sale, *A* makes the highest bid. But he withdraws the bid before the fall of the hammer. There cannot be a concluded contract because the offer has been revoked before acceptance.

Further, an offer, agreed to be kept open for a definite period, may be revoked even before the expiry of that period, unless there is some consideration for so keeping it open. The effect of fixing a time for acceptance is merely to fix a time beyond which the offer cannot be accepted. Where no time limit is set, the offer cannot be accepted after a reasonable time. A promise to keep an offer open for a definite period, unsupported by consideration, is regarded as a 'bare pact,' and hence not binding on the promisor (*Dickinson* vs *Dodds*[18]). A promise to keep an offer open, supported by consideration, is called an 'option'. An 'option' is in effect a separate contract making the promisor liable for breach if he revokes the offer before the expiry of agreed time.

ILLUSTRATION. *M* offers to sell his house to *N* for Rs 1,40,000. *N* says to *M* that if he agrees to keep the offer open for 10 days he (*N*) will pay him Rs 1,000. *M* agrees. *M* cannot revoke the offer before the expiry of 10 days, as *N* has obtained an option to purchase the house within 10 days. If *M* revokes the offer before the expiry of 10 days, he can be sued for breach of option contract.

A revocation of an offer must be communicated or made known to the offeree, otherwise the revocation does not prevent acceptance. Revocation of a 'general offer' must be made through the same channel by which the original offer was made. Again, revocation must always be express and must be communicated by the offeror himself or his duly authorised agent to the other party.

Revocation of standing offer or tender. Where a person offers to another to supply specific goods, up to a stated quantity or in any quantity which may be required, at a certain rate, during a fixed period, he makes a standing offer or tender. A standing offer is in the nature of an *open or continuing offer*. An acceptance of such an offer merely amounts to an intimation that the offer will be considered to remain open during the period specified, and that it will be accepted from time to time by placing order for specified quantities. Each successive order given, while the offer remains in force, is an acceptance of the standing offer as to the quantity ordered, and creates a separate contract. In view of this legal position, the offeror is free to revoke the standing offer with regard to further supply, at

[18](1876), 2 Ch. D. 463.

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any time, by giving a notice to the offeree, except where consideration is given for it.

6. **Revocation by non-fulfilment of a condition precedent to acceptance.** An offer stands revoked if the offeree fails to fulfil a condition precedent to acceptance [Sec. 6 (3)]. Thus, where *A*, offers to sell his scooter to *B*, for Rs 4,000, if *B* joins the Lions Club within a week, the offer stands revoked and cannot be accepted by *B*, if *B* fails to join the Lions Club.

7. **An offer lapses by subsequent illegality or destruction of subject matter.** An offer lapses if it becomes illegal after it is made, and before it is accepted. Thus, where an offer is made to sell 10 bags of wheat for Rs 6,500, and before it is accepted, a law prohibiting the sale of wheat by private individuals is enacted, the offer comes to an end. In the same manner, an offer may lapse if the thing, which is the subject matter of the offer, is destroyed or substantially impaired before acceptance.

THE ACCEPTANCE

A contract, as already observed, emerges from the acceptance of an offer. Section 2(b) states that "A proposal when accepted becomes a promise" and defines 'acceptance' as "when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted." Thus, 'acceptance' is the manifestation by the offeree of his assent to the terms of the offer.

Legal Rules Regarding a Valid Acceptance

A valid acceptance must be in conformity with the following rules:

1. **Acceptance must be given only by the person to whom the offer is made.** An offer can be accepted only by the person or persons to whom it is made and with whom it imports an intention to contract; it cannot be accepted by another person without the consent of the offeror. The rule of law is clear that "if you propose to make a contract with *A*, then *B* can't substitute himself for A without your consent." An offer made to a particular person can be validly accepted by him alone. Similarly an offer made to a class of persons (*i.e.*, teachers) can be accepted by any member of that class. An offer made to the world at large can be accepted by any person who has knowledge of the existence of the offer.

ILLUSTRATION. *A* sold his business to his manager *B* without disclosing the fact to his customers. *C*, a customer, who had a running account with *A*, sent an order for the supply of goods to *A* by name. *B* received the order and executed the same. *C* refused to pay the price. It was held that there was no contract between *B* and *C* because *C* never made any offer to *B* and as such *C* was not liable to pay the price to *B* (*Boulton* vs *Jones*[19]).

[19](1857), 157 E.R. 232.

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2. **Acceptance must be absolute and unqualified** [Sec. 7 (1)]. In order to be legally effective it must be an absolute and unqualified acceptance of all the terms of the offer. Even the slightest deviation from the terms of the offer makes the acceptance invalid. In effect a deviated acceptance is regarded as a counter offer in law.

ILLUSTRATION. *L* offered to *M* his scooter for Rs 4,000. *M* accepted the offer and tendered Rs 3,900 cash down, promising to pay the balance of Rs 100 by the evening. There is no contract, as the acceptance was not absolute and unqualified.

3. **Acceptance must be expressed in some usual and reasonable manner, unless the proposal prescribes the manner in which it is to be accepted** [Sec. 7 (2)]. If the offeror prescribes no mode of acceptance, the acceptance must be communicated according to some usual and reasonable mode. The usual modes of communication are by word of mouth, by post and by conduct. When acceptance is given by words spoken or written or by post or telegram, it is called an *express acceptance.* When acceptance is given by conduct, it is called an *implied or tacit acceptance.* Implied acceptance may be given *either* by doing some required act, for example, tracing the lost goods for the announced reward, *or* by accepting some benefit or service, for example, stepping in a public bus by a passenger.

If the offeror prescribes a mode of acceptance, the acceptance given accordingly will no doubt be a valid acceptance, even if the prescribed mode is funny. Thus, if an offeror prescribes lighting a match as a mode of acceptance and the offeree accordingly lights the match, the acceptance is effective and complete. But what happens if the offeree deviates from the prescribed mode? The answer to this query is given in Section 7(2) itself which states that in cases of deviated acceptances "the proposer may, within a reasonable time after the acceptance is communicated to him, insist that his proposal shall be accepted in the prescribed manner, and not otherwise; but, if he fails to do so, he accepts the (deviated) acceptance."

ILLUSTRATION. If the offeror prescribes 'acceptance by telegram' and the offeree sends acceptance through a messenger, there is no acceptance of the offer, if the offeror informs the offeree that the acceptance is not according to the mode prescribed. But if the offeror fails to do so, it will be presumed that he has accepted the acceptance and a valid contract will arise.

It should be noted that law does not allow an offeror to prescribe 'silence' as the mode of acceptance. Thus, a person cannot say that if within a certain time acceptance is not communicated the offer would be considered as accepted. Similarly, a trader who, of his own without receiving any order, sends goods to some person with a letter saying "If I do not hear from you by the next Monday, I shall presume that you have bought the goods," cannot impose a contract on the unwilling recipient. It is so because in the absence of such a rule the offerees will be at the mercy of offerors, unless

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they reply all such offers in negative which will certainly be causing a lot of inconvenience and financial burden to them.

Mental acceptance ineffectual. Mental acceptance or quiet assent not evidenced by words or conduct does not amount to a valid acceptance; and this is so even where the offeror has said that such a mode of acceptance will suffice. Acceptance must be communicated to the offeror, otherwise it has no effect. Thus, if an oral acceptance is spoken into a telephone after the telephone has gone dead, there is in effect no acceptance. This rule is based on the theory of *consensus ad idem* or of identity of minds. Unless the acceptance of the offer comes to the knowledge of the offeror, there is no identity of mind and therefore no contract.

ILLUSTRATIONS. (*a*) Felthouse offered by letter to buy his nephew's horse for £ 30, 15s., adding, "If I hear no more about him I shall consider the horse mine at £ 30, 15s." The nephew sent no reply to this letter but told Bindley, an auctioneer, to keep the horse out of a sale of his farm stock, as he intended to reserve it for his uncle Felthouse. Bindley sold the horse by mistake, and Felthouse sued him for conversion of his property. The Court held that as there was no communication of acceptance to Felthouse before the auction sale took place, there was no contract and therefore Felthouse had no right to complain of the sale. (*Felthouse* vs *Bindley*[20])

(*b*) A person received an offer by letter. In reply he wrote a letter of acceptance, put the letter in his drawer and forgot all about it. Held, this uncommunicated acceptance did not amount to acceptance and so did not complete the contract. (*Brogden* vs *Metropolitan Rly. Co*[21])

4. **Acceptance must be communicated by the acceptor.** For an acceptance to be valid, it must not only be made by the offeree but must also be communicated by, or with the authority of, the offeree (or acceptor) to the offeror.

ILLUSTRATION. In *Powell* vs *Lee*[22], *P* was a candidate for the post of headmaster in a school. The managing committee of the School passed a resolution selecting him for the post. A member of the managing committee, acting in his individual capacity, informed *P* that he had been selected, but *P* received no other intimation. Subsequently, the resolution was cancelled, and *P* was not appointed to the post. *P* filed a suit against the Committee for breach of contract. The Court held that in the absence of an authorised communication from the Committee there was no binding contract.

5. **Acceptance must be given within a reasonable time and before the offer lapses and/or is revoked.** To be legally effective acceptance must be given within the specified time limit, if any, and if no time is stipulated, acceptance must be given within a reasonable time. Where *M* applied for

[20](1863), 7 L.T. 835.
[21](1877), A.C. 666.
[22](1908), 99 L.T. 284.

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certain shares in a company in June but the allotment was made in November and he refused to accept the allotted shares, it was held that the offeror (*M*) could refuse to take shares as the offer stood withdrawn and could not be accepted because the reasonable period during which the offer could be accepted had elapsed (*Ramsgate Victoria Hotel Co.* vs *Montefiore*[23]). Again, the acceptance must be given before the offer is revoked or lapses by reason of offeree's knowledge of the death or insanity of the offeror.

6. **Acceptance must succeed the offer.** Acceptance must be given after receiving the offer. It should not precede the offer. In a company shares were allotted to a person who had not applied for them. Subsequently he applied for shares being unaware of the previous allotment. It was held that the allotment of shares previous to the application was invalid.

7. **Rejected offers can be accepted only, if renewed.** Offer once rejected cannot be accepted again unless a fresh offer is made (*Hyde* vs *Wrench*[24]).

Communication of Offer, Acceptance and Revocation

When the contracting parties are face to face and negotiate in person, there is instantaneous communication of offer and acceptance, and a valid contract comes into existence the moment the offeree gives his absolute and unqualified acceptance to the proposal made by the offeror. The question of revocation of either offer or acceptance does not arise, for, in such cases a definite offer is made and accepted instantly at one and the same time.

But where services of the post office are utilised for communicating among themselves by the contracting parties because they are at a distance from one another, it is not always easy to ascertain the exact time at which an offer or/and an acceptance is made or revoked. In these cases the following rules, as laid down in Sections 4 and 5, will be applicable:

1. **Communication of an offer.** The communication of an offer is complete when it comes to the knowledge of the person to whom it is made, *i.e.*, when the letter containing the offer reaches the offeree.

2. **Communication of an acceptance.** The communication of an acceptance has two aspects, *viz.*, as against the proposer and as against the acceptor. The communication of an acceptance is complete (*a*) *as against the proposer,* when it is put in a course of transmission to him, so as to be out of power of the acceptor, and (*b*) *as against the acceptor,* when it comes to the knowledge of the proposer *i.e.*, when the letter of acceptance is received by the proposer.

ILLUSTRATIONS. (*i*) *A* proposes, by letter, to sell a house to *B* for

[23](1866), L.R. 1 Ex. 109.
[24](1840), 3 Beav. 334.

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Rs. 80,000. The letter is posted, on 6th instant. The letter reaches *B* on 8th instant. The communication of the offer is complete when *B*, the offeree, receives the letter *i.e.*, on 8th.

(*ii*) *B* accepts *A*'s proposal, in the above case, by a letter sent by post on 9th instant. The letter reaches *A* on 11th instant. The communication of the acceptance is complete: *as against A*, when the letter is posted *i.e.*, on 9th, and *as against B*, when the letter is received by *A*, *i.e.*, on 11th.

3. **Communication of a revocation.** The communication of a revocation is complete: (*a*) *as against the person who makes it,* when it is put into a course of transmission to the person to whom it is made, so as to be out of the power of the person revoking, *i.e.*, when the letter of revocation is posted, and (*b*) *as against the person to whom it is made,* when it comes to his knowledge, *i.e.*, when the letter of revocation is received by him.

ILLUSTRATIONS. (*a*) In the illustration (*i*) given above, *A* revokes his offer by letter on 8th instant. The letter reaches *B* on 10th instant. The revocation is complete as against *A* on 8th, when the letter of revocation is posted. It is complete as against *B* on 10th, when the letter of revocation is received by him.

(*b*) In the illustration (*ii*) given above, *B* revokes his acceptance by letter on 10th instant. The letter reaches *A* on 12th instant. The revocation is complete as against *B* on 10th, the date on which the letter of revocation is posted and as against *A* on 12th, the date on which the letter reaches him.

Time during which an offer or acceptance can be revoked. In the illustrations (*a*) and (*b*) given above, there arises a question: whether the revocation of offer by *A* is operative or not, or whether the revocation of acceptance by *B* is operative or not? For answering this question, it is necessary to know the limit of time within which an offer or acceptance can be revoked. Section 5 deals with this question and provides as follows:

"A proposal may be revoked at any time before the communication of its acceptance is complete as against the proposer, but not afterwards. An acceptance may be revoked at any time before the communication of the acceptance is complete as against the acceptor but not afterwards."

Applying Section 5 to our illustrations given above: *A* may revoke his offer at any time before or at the moment when *B* posts his letter of acceptance *i.e.*, 9th, but not afterwards. *B* may revoke his acceptance at any time before or at the moment when the letter of acceptance reaches *A i.e.*, 11th, but not afterwards. While discussing the rule regarding 'communication of revocation', we have observed earlier that the revocation of offer is complete as against *B* (the acceptor) on 10th, when the letter of revocation is received by him. As *B* posts his letter of acceptance on 9th and the communication of acceptance is complete as against *A* on the day of posting itself *i.e.*, 9th, *A*'s revocation of his offer, which is complete as against *B* on 10th, is inoperative. *B*'s acceptance is valid and there shall be a binding contract.

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For the sake of practice of the rules regarding communication of offer, acceptance and revocation discussed above, we take *another illustration.*

ILLUSTRATION. (*i*) *A* offers, by letter, to sell his car to *B* for Rs 75,000 on 1st August. *B* receives the letter on 3rd August.

(*ii*) *B* puts the letter of acceptance in post on 4th August, which reaches *A* on 6th.

(*iii*) *A* writes a letter of revocation of his offer and posts it on 3rd August, which reaches *B* on 5th August.

Rules applied. (*i*) Communication of offer is complete on 3rd August *i.e.*, when it comes to the knowledge of *B*.

(*ii*) Communication of acceptance is complete as against the proposer *i.e.*, A, when the letter of acceptance is posted *i.e.*, on 4th, and as against the acceptor *i.e.*, *B*, when the letter of acceptance reaches the proposer *i.e.*, on 6th August.

(*iii*) Revocation of offer is complete as against *A* on 3rd August, when the letter of revocation is posted, and as against *B* on 5th August, when the letter of revocation is received by him.

(*iv*) As *B* has put his acceptance into transmission on 4th August and revocation of offer is communicated to him on 5th August, his acceptance is valid and there shall be a binding contract. *A*, cannot revoke his offer after 4th August, when the communication of acceptance is complete as against him.

Effect of delay or loss of letter of acceptance in postal transit. *So far as the offeror is concerned,* he is bound by the acceptance the moment the letter of acceptance is posted, although the letter is delayed or wholly lost through an accident of the post and the letter never in fact reaches him. But in order to bind the offeror, the letter of acceptance must be correctly addressed, properly stamped and actually posted. If the letter of acceptance is misdirected because it has not been addressed correctly, there would, in law, be no communication of the acceptance; but if the wrong address is furnished by the offeror himself, he will be bound. *So far as the acceptor is concerned,* he is not bound by the letter of acceptance till it reaches the offeror. Until the letter of acceptance reaches the offeror, the contract remains voidable at the instance of the acceptor. He can compel the offeror to enforce the contract or he may revoke his acceptance by communicating his revocation at any time before the letter reaches the offeror. Thus the acceptor is at an advantage if the letter is delayed or lost in transit.

Accidental formation of contract. There remains yet another query: what happens if both the 'letter of acceptance' and the 'telegram of revocation of acceptance' are delivered to the offeror at the same time? In such a situation the formation of contract will depend on a matter of chance. If the offeror reads the letter of acceptance first and then the telegram, a binding contract will arise. But if the offeror reads the telegram of revocation of acceptance first and then the letter of acceptance, there will be no binding contract because the communication of revocation comes to the offeror's notice first than the communication of acceptance. It will be seen

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that the formation of contract in the aforesaid circumstance depends on a matter of chance and therefore such contracts are called 'accidental form of contracts'.

Contracts over the Telephone

In the case of contracts over the telephone, each contracting party is able to hear the voice of the other. There is instantaneous communication of offer and acceptance, rejection and counter offer. And therefore, the rule which applies to contracts negotiated orally by the parties in the physical presence of each other *i.e.*, the contract is complete only when the acceptance is received by the offeror also applies to contracts made over the telephone. If the acceptance is not in fact communicated to the offeror because the telephone suddenly goes'dead,' there will be no contract (*Entores Ltd.* vs *Miles Far East Corporation*).[25] The offeree, therefore, must make sure that his acceptance is received (heard and understood) by the offeror, otherwise there is no binding contract. The observation made by Denning, L.J, in *Entores Case*[26] is enlightening in this connection:

"Now take a case where two people make a contract by telephone. Suppose for instance, that I make an offer to a man by telephone and in the middle of his reply, the line goes 'dead' so that I do not hear his words of acceptance. There is no contract at that moment. The other man may not know the precise moment when the line failed. But he will know that the telephonic conversation was abruptly broken off, because people usually say something to signify the end of the conversation. If he wishes to make a contract, he must, therefore, get through again so as to make sure that I heard. Suppose next that the line does not go dead but it is nevertheless so indistinct that I do not catch what he says and I ask him to repeat it. He then repeats it and I hear his acceptance. The contract is made, not on the first time when I do not hear, but only the second time when I do hear. If he does not repeat it, there is no contract. The contract is only complete when I have his answer accepting the offer".

In *Kanhialal* vs *Dineshchandra*[27] it has been so held in India as well that where a contract is effected by telephonic conversation, the contract is not complete till acceptance of the offer by the offeree is clearly heard and understood by the offeror.

No question of revocation. When the parties negotiate a contract over telephone, no question of revocation can possibly arise, for in such instantaneous communication, a definite offer is made and accepted at one and the same time. An offer when accepted, explodes into a contract and cannot

[25](1955), 1 All. E.R. 493.
[26]Ibid.
[27](1959), A.I.R., M.P. 234.

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be revoked. In the words of Sir Anson: "Acceptance is to an offer what a lighted match is to a train of gunpowder. It produces something which cannot be recalled or undone."[28]

TEST QUESTIONS

1. Define the term 'offer'. Explain the legal rules regarding a valid offer.
2. "An invitation to offer is not an offer." Elucidate the statement.
3. Discuss the circumstances under which an offer lapses and stands revoked. Give examples.
4. What do you understand by the term 'acceptance'? What are the essentials of a valid acceptance?
5. "A mere mental acceptance, not evidenced, by words or conduct is, in the eye of law, no acceptance."Explain by giving examples.
6. Discuss briefly the law relating to communication of offer, acceptance and revocation. Is there any limit of time after which offer and acceptance cannot be revoked?
7. Define offer and acceptance. When are offer and acceptance deemed to be complete if made through post?
8. "Acceptance is to an offer what a lighted match is to a train of gun powder. It produces something which cannot be recalled or undone" — Anson. Comment on the statement and briefly discuss the essentials of a valid offer and acceptance.

PRACTICAL PROBLEMS

Answer the following problems, giving reasons for your answers:

1. Harish says in conversation to Suresh that he will give Rs 10,000 to a person whosoever marries his daughter. Alok marries Harish's daughter and files a suit to recover Rs 10,000. Will he succeed?

[**Hint**. No, Harish has expressed his wish only, and has never made an offer with a view to obtaining the assent of the other party.]

2. *X* sees a book displayed in a shelf of a book shop with a price tag of Rs 85. *X* tenders Rs 85 on the counter and asks for the book. The bookseller refuses to sell saying that the book has already been sold to someone else and he does not have another copy of that book in the stock. Is the bookseller bound to sell the book to *X*?

[**Hint**. No, a display of goods with prices marked thereon is only an invitation for offer, and not an offer itself. Hence the bookseller is free to accept the offer or not.]

3. *B* offered to sell his car to *A* for Rs 95,000. *A* accepts to purchase it for Rs 94,500. *B* refused to sell the car for Rs 94,500. Subsequently *A* agrees to purchase the car for Rs 95,000 but *B* refused to sell the car. *A* sues *B* for the specific performance of the contract. Will he succeed?

[**Hint**. No, *B*'s offer comes to an end by the counter offer of *A*, and there was

[28]Anson's Law of Contract, 23rd Ed. p.55.

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no offer available for acceptance subsequently.]

4. *P* sold his business to *Q* without disclosing this to his customers. *M*, an old customer sent an order for goods to *P* by name. *Q*, the new owner, executed the order. Is *M* bound to accept the goods?

[**Hint**. No, *M* is not bound to accept the goods because a specific offer made to *P* can be accepted only by *P* and none else (*Boulton* vs *Jones*).]

5. *B* offered to sell his house to *A* for Rs 50,000. *A* accepted the offer by post. On the next day *A* sent a telegram revoking the acceptance which reached *B* before the letter. Is the revocation of acceptance valid? Would it make any difference if both the letter of acceptance and the telegram of revocation of acceptance reach *B* at the same time?

[**Hint.** Yes, the revocation of acceptance is valid because the acceptor may revoke his acceptance at any time before the letter of acceptance reaches the offeror. If the letter of acceptance and the telegram of revocation of acceptance reach *B* at the same time, the formation of contract will depend on the fact that which of the two is opened first by *B*. If *B* reads the telegram first, revocation is valid but if he reads the letter first, revocation is not possible.]

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Chapter 3

Consideration

Consideration is one of the essential elements of a valid contract (Sec. 10). It is an important element, for it imports in a measure the safeguard of deliberation. The fact of its existence serves to distinguish those promises by which the promisor intends to be legally bound from those which are not seriously meant. In the words of Blackstone: "A consideration of some sort or other is so necessary to the forming of a contract, that a *nudum pactum,* or agreement to do or pay something on one side, without any compensation on the other, will not at law support an action; and a man cannot be compelled to perform it... The law supplies no means nor affords any remedy to compel the performance of an agreement made without consideration. If I promise a man £ 100 for nothing, he neither doing nor promising anything in return or to compensate me for my money, my promise has no force in law." The breach of a *gratuitous promise* cannot be redressed by legal remedies. It is only when a promise is made in return of 'something' from the promisee, that such promise can be enforced by law against the promisor. This 'something' in return is the consideration for the promise. In the language of purchase and sale Pollock has observed: "Consideration is the price for which the promise of the other is bought."[1] Thus consideration is the very foundation of a contract. "Subject to certain exceptions,[2] agreements without consideration are void" (Sec. 25).

Definition

Section 2(d) of the Indian Contract Act defines consideration as follows: "When at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or abstain from doing, something, such act or abstinence or promise is called a consideration for the promise."

An analysis of the above definition will show that it consists of the

[1]Pollock on Contracts, 13th edn.,p. 113.

[2]These exceptions have been discussed later in the present chapter under the heading 'No Consideration Necessary'.

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following four components:

(*a*) the act or abstinence or promise which forms the consideration for the promise, must be done *at the desire of the promisor;*

(*b*) it must be done *by the promisee or any other person;*

(*c*) it may have been already *executed* or is *in the process of being done or* may be still executory;

(*d*) it must be *something* to which the law attaches a value.

ILLUSTRATIONS. (*i*) *A* agrees to sell his house to *B* for Rs 10,000. Here *B*'s promise to pay the sum of Rs 10,000 is the consideration for *A*'s promise to sell the house, and *A*'s promise to sell the house is the consideration for *B*'s promise to pay the sum of Rs 10,000.[3]

(*ii*) *A* promises to maintain *B*'s child and *B* promises to pay *A* Rs 1,000 yearly for the purpose. Here the promise of each party is the consideration for the promise of the other party.[3]

(*iii*) *A* promises to pay *B* Rs 1,000 at the end of six months, if *C*, who owes that sum to *B*, fails to pay it. *B* promises to grant time to *C* accordingly. Here the promise of each party is the consideration for the promise of the other party.[3]

(*iv*) *A* promises his debtor *B* not to file a suit against him for one year on *B*'s agreeing to pay him Rs 100 more. The abstinence of *A* is the consideration for *B*'s promise to pay.

(*v*) *A* promises to type the manuscript of *B*'s book, and in return *B* promises to teach *A*'s son for a month. The promise to each party is the consideration for the promise of the other party.

(*vi*) A person had a daughter to marry and in order to raise funds for her marriage he intended to sell a property. His son promised that if the father would forbear to sell, he would pay the father Rs. 50,000. The father accordingly forbore. The abstinence of the father is the consideration for son's promise to pay.

Essentials of Valid Consideration

The four component parts of the definition of consideration (given above) may well be described as the essentials of valid consideration. We shall now discuss these essentials one by one in detail.

1. **Consideration must move at the desire of the promisor.** In order to constitute legal consideration, the act or abstinence forming the consideration for the promise must be done *at the desire or request of the promisor.* Thus acts done or services rendered voluntarily, or at the desire of third party, will not amount to valid consideration so as to support a contract. The logic for this may be found in the worry and expense to which every one might be subjected, if he were obliged to pay for services, which he does not need or require.

ILLUSTRATIONS. (*a*) *A* sees *B*'s house on fire and helps in extinguishing it. He cannot demand payment for his services because *B* never asked him to come for help.

[3]Illustration appended to Section 23.

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(*b*) *D* had built, at his own expense, a market at the request of the Collector of the District. The shopkeepers in the market promised to pay *D* a commission on the articles sold by them in the market. When *D* sued the shopkeepers for the commission, it was held that the promise to pay commission did not amount to a contract for want of consideration, because *D* (the promisee) had constructed the market not at the desire of the shopkeepers (the promisors) but at the desire of the Collector to please him (*Durga Prasad* vs *Baldeo*).[4]

It must be noted that this essential does not require that the consideration must confer 'some benefit' on the promisor. It would be enough if the act or forbearance or promise constituting the consideration was done or given at the promisor's request, the benefit may accrue to a third party.

ILLUSTRATIONS. (*a*) *B* requests *A* to sell and deliver to him goods on credit. *A* agrees to do so, provided *C* will guarantee the payment of the price of the goods. *C* promises to guarantee the payment. The contract between *A* and *C* is a 'contract of guarantee' and is perfectly valid though the benefit which *A* confers in return of *C*'s guarantee is conferred not on *C* but on *B* (in the shape of sale of goods on credit). *A*'s promise to deliver the goods is the consideration for *C*'s promise of guarantee. (Illustration appended to Section 127).

(*b*) *A*, who owed Rs 20,000 to *B*, persuaded *C* to pass a promissory note for the amount in favour of *B*. *C* promised *B* that he would pay the amount (by passing on a promissory note), and *B* credited the amount to *A*'s Account in his books. The discharge of *A*'s Account was consideration for *C*'s promise (though *C* the promisor had received no benefit) (*National Bank of Upper India* vs *Bansidhar*[5]).

2. **Consideration may move from the promisee or any other person.** The second essential of valid consideration, as contained in the definition of consideration in Section 2 (d), is that consideration need not move from the promisee alone but may proceed from a third person. Thus, as long as there is a consideration for a promise, it is immaterial who has furnished it. It may move from the promisee or from any other person. This means that even a *stranger to the consideration can sue* on a contract, provided he is a party to the contract. This is sometimes called as 'Doctrine of Constructive Consideration'. The leading case of *Chinayya* vs *Ramayya*[6] provides a good illustration on the point:

ILLUSTRATION. In the above case *A*, an old lady, by a deed of gift, made over certain property to her daughter *R*, with a direction that the daughter should pay an annuity to *A*'s brother *C*, as has been done by *A*. Accordingly, on the same day *R*, the daughter, executed a writing in favour of her maternal uncle *C* agreeing to pay the annuity. Afterwards she declined to fulfil her promise saying that no consideration had moved from her maternal uncle *i.e.*, the promisee. It was held that the words "the promisee or any other person" in Section 2 (*d*) clearly show that a stranger to consideration may maintain a suit. Hence the maternal uncle, though a stranger to the consideration (as the consideration indirectly moved from his

[4](1881),3 All.221.
[5](1930), 5 Luck. 1 (P.C.).
[6](1881), 4 Mad. 137.

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sister) was entitled to maintain the suit.

In the above case, it will be observed, that although *C*, the maternal uncle, was a stranger to the consideration, he was not a stranger to the contract as there was a separate contract between him and *R*, the daughter. The maternal uncle could not have sued on the basis of 'gift deed' executed by *A* in favour of *R* because he was not a party to it.

A stranger to a contract cannot sue. A person may be a stranger to the consideration but he should not be a stranger to the contract because 'privity of contract' is essential for enforcing any of the rights arising out of the contract. It being a fundamental principle of the law of contracts that *'a stranger to a contract cannot sue, only a person who is a party to a contract can sue on it.'* Thus, where A mortgages his property to *B* in consideration of *B*'s promise to *A* to pay *A*'s debt to *C*, *C* cannot file a suit against *B* to enforce his promise, *C* being no party to the contract between *A* and *B* (*Iswaram Pillai* vs *Sonnivaveru*[7]).

Exceptions. The above rule that 'a stranger to a contract cannot sue' is subject to the following exceptions:

(i) Where an express or implied trust is created. In case of a trust, the beneficiary can sue in his own right to enforce his rights under the trust, though he was not a party to the contract between the settler and the trustees.

ILLUSTRATIONS. (*a*) *A* transfers certain properties to *B* to held by *B* in trust for the benefit of *M*. *M* can enforce the agreement *i.e.*, trust (*M.K.Rapai* vs *John*[8]).

(*b*) An addressee of an insured article is entitled to sue the Post Office in case of loss, as on receipt of such article, the Post Office becomes in law a constructive trustee for the addressee *(Amir Ullah* vs *Central Govt.*[9]).

(*ii*) *Family settlement.* Where a provision is made in a partition or family arrangement for maintenance or marriage expenses of female members; such members, though not parties to the agreement, can sue on the footing of the arrangement.

ILLUSTRATION. A daughter along with her husband entered into a contract with her father whereby it was agreed that she will maintain her mother and the property of the father will be conveyed to them. The daughter subsequently refused to maintain the mother. On a suit it was held that the mother was entitled to require her daughter to maintain her, though she was a stranger to the contract (*Veeramma* vs *Appayya).*[10]

(*iii*) *When the defendant constitutes himself, as the agent of the third party.* Thus if *A* receives some money from *B* to be paid over to *C* and he admits of this receipt to *C*, then *C* can recover this amount from *A* who shall

[7](1915), 38 Mad. 753.
[8](1965), A.I.R. Ker. 203.
[9](1959), All. L.J. 271.
[10](1957), A.I.R. AP 965.

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be regarded as the agent of *C* (*Surjan* vs *Nanat*).[11]

(*iv*) *In case of agency.* Where a contract is entered into by an agent, the principal can use on it.

(*v*) *In case of assignment of rights under a contract* in favour of a third party either voluntarily or by operation of law, the assignee can enforce the benefits of the contract, e.g., the assignee of an insurance policy or the official assignee on the insolvency of a person can sue on the contract even though originally they were not parties to it.

3. **Consideration may be past, present or future.** The words, "has done or abstained from doing; or does or abstains from doing; or promises to do or to abstain from doing," used in the definition of consideration clearly indicate that the consideration may consist of *either* something done or not done in the past, *or* done or not done in the present, *or* promised to be done or not done in the future. *To put it briefly, consideration may consist of a past, present or a future act or abstinence.*

Consideration may consist of an act or abstinence. Consideration may consist of *either* a positive act or an abstinence *i.e.*, a negative act. Thus, an agreement between *B* and *A*, under which *B*; on failing to pay the debt amount on the due date to *A*; promises to raise the rate of interest from 9 per cent to 12 per cent in consideration of *A* promising not to file a suit against him for another one year, is a valid contract; *A*'s abstinence being the consideration for *B*'s promise.

Past consideration. When something is done or suffered before the date of the agreement, *at the desire of the promisor,* it is called 'past consideration.' It must be noted that past consideration is good consideration only if it is given by the promisee, 'at the desire of the promisor.'

ILLUSTRATIONS. (*a*) *A* teaches the son of *B* at *B*'s request in the month of January, and in February *B* promises to pay *A* a sum of Rs 200 for his services. The services of *A* will be past consideration.

(*b*) A lawyer, gave up his practice and served as manager of a landlord at the latter's request in lieu of which the landlord subsequently promised a pension. It was held that there was good past consideration. (*Shiv Saran* vs *Kesho Prasad*)[12]

Present consideration. Consideration which moves simultaneously with the promise, is called 'present consideration' or 'executed consideration'. For example, *A* sells and delivers a book to *B*, upon *B*'s promise to pay for it at a future date. The consideration moving from *A* is present or executed consideration since *A* has done his act of delivering the book simultaneously with the promise of *B*. It should, however, be noted that it is said to be 'present consideration' when at the time of the agreement it is executed on one side and executory on the other. If both parties have done their part

[11](1940), A.I.R. Lah. 471.

[12]42 I.C. 122.

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under the contract, *e.g.*, where *A* sells a book to *B* and *B* pays its price immediately, it is a case of *executed contract* (where nothing remains to be done) and not of executed or present consideration.

Future consideration. When the consideration on both sides is to move at a future date, it is called 'future consideration' or 'executory consideration'. It consists of an exchange of promises and each promise is a consideration for the other. For example, *X* promises to sell and deliver 10 bags of wheat to *Y* for Rs 6,500 after a week, upon *Y*'s promise to pay the agreed price at the time of delivery. The promise of *X* is supported by promise of *Y* and the consideration is executory on both sides. It is to be observed that in an 'executed consideration', the liability is outstanding against only one side whereas in an 'executory consideration' it is outstanding on both sides.

4. **Consideration must be 'something of value'**. The fourth and last essential of valid consideration is that it must be 'something' to which the law attaches a value. The consideration need not be adequate to the promise for the validity of an agreement. The Law only insists on the presence of consideration and not on the adequacy of it. It leaves the people free to make their own bargains. Thus, where *A* agrees to sell his motorcar worth Rs 20,000 for Rs 1,000 only and his consent is free, the agreement is a valid contract, notwithstanding the inadequacy of the consideration. However, if the consideration be grossly or shockingly inadequate, and if one of the parties to the contract alleges that his consent was obtained by fraud, coercion or undue influence, the court will treat inadequacy of consideration as an evidence in support of such allegation and will declare the contract void.[13]

Inadequacy of consideration being no bar to a valid contract, unless it is an evidence of unfree consent, it has been correctly observed that "in many cases, the doctrine of consideration is a mere technicality irreconcilable either with business expediency or common sense."

Consideration must be real. Though consideration need not be adequate, it must be of some value in the eye of law, *i.e.*, it must be real and competent. Where consideration is physically impossible, illegal, uncertain or illusory, it is not real and therefore shall not be a valid consideration.

(*i*) *Physically impossible.* A promise to do something which is physically impossible, *e.g.*, to make a dead man alive or to run at a speed of 100 kilometres per hour, does not form valid consideration.

(*ii*) *Legally impossible.* A promise to do something which is illegal,

[13]"An agreement to which the consent of the promisor is freely given is not void merely because the consideration is inadequate; but the inadequacy of the consideration may be taken into account by the Court in determining the question whether the consent of the promisor was freely given." (Explanation 2, to Section 25).

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e.g., a promise for illegal cohabitation, does not amount to good consideration.[14]

(*iii*) *Uncertain consideration.* A promise to do something which is too vague and uncertain, *e.g.*, a promise to pay such remuneration "as shall be deemed right," is no consideration in the eye of law.

(*iv*) *Illusory consideration.* Again, an illusory or deceptive consideration does not amount to a valid consideration. Consideration is illusory if it consists in a promise to perform a public duty, or to perform a contract already made with the promisor.

ILLUSTRATIONS. (*a*) *C* (the plaintiff) received a subpoena (a kind of summon) to appear at a trial as a witness on behalf of *G* (the defendant). *G* promised him a sum of money for his trouble. On default by *G*, *C* filed the suit for the recovery of the promised sum. It was held that *C* being under a public duty to attend and give evidence, there was no consideration for the promise and hence the promise is unenforceable. (*Collins* vs *Godefroy*[15])

(*b*) Two of the crew of a ship deserted it half way while the ship was on a voyage from London to the Baltic and back. The captain, being unable to supply their place, promised the rest of the crew that, if they would work the vessel home, the wages of the two deserters should be equally divided amongst them. The agreement was held to be void for want of consideration because it was the contractual duty of the mariners who remained with the ship to exert themselves utmost in any emergency of the voyage to bring the ship in safety to her destined port... The desertion of a part of the crew is to be considered an emergency of the voyage as much as their death. (*Stilk* vs *Myrick*)[16]

However, in the following cases consideration has been regarded as real and valid:

(*i*) *Forbearance to sue.* Forbearance to sue, at the instance of the debtor, is sufficient consideration. *A*, has a right to sue his debtor *B* for Rs 5,000, but infact forbears as *B* agreed to pay Rs 100 more. Such forbearance is a valuable consideration for the promise, being in the nature of abstinence, and *A* can later on sue *B* for Rs 5,100. But in order that the forbearance should be a consideration, there must be existing and lawful liability.

(*ii*) *Compromise of a pending suit.* The compromise of a disputed or doubtful claim is a good consideration for the fresh agreement of compromise. (*Sunder Singh* vs *Haro*)[17]

No Consideration Necessary

Consideration being one of the essential elements of a valid contract,

[14]The topic of 'Unlawful Consideration' has been discussed in detail, later in the chapter on '*Legality of the Object and Consideration*'.

[15](1831), I.B. & Ad. 950.

[16](1809), 2 Camp. 317.

[17](1929), 116 IC 719.

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the general rule is that "an agreement made without consideration is void." But there are a few exceptions to the rule, where an agreement without consideration will be perfectly valid and binding. These exceptions are as follows:

1. **Agreement made on account of natural love and affection** [Sec. 25 (1)]. An agreement made without consideration is enforceable if, it is (*i*) expressed in writing, and (*ii*) registered under the law for the time being in force for the registration of documents, and is (*iii*) made on account of natural love and affection, (*iv*) between parties standing in a near relation to each other. Thus there are four essential requirements which must be complied with to enforce an agreement made without consideration, as per Section 25 (1).

ILLUSTRATIONS. (*a*) *A* promises, for no consideration, to give to *B* Rs 1,000. This is a void agreement.[18]

(*b*) *A* for natural love and affection, promises to give his son *B*, Rs 1,000. *A* puts his promise to *B* into writing and registers it. This is a contract.[18]

(*c*) A registered agreement, whereby an elder brother, on account of natural love and affection, promised to pay the debts of his younger brother, was held to be valid and binding and the younger brother could sue the elder brother in the event of his not carrying out the agreement. *(Venkatasamy* vs *Rangasami*[19])

It should, however, be noted that mere existence of a near relation between the parties does not necessarily import natural love and affection. Thus where a Hindu husband, after referring to quarrels and disagreement between him and his wife, executed a registered document in favour of his wife, agreeing to pay for separate residence and maintenance, it was held that the agreement was void for want of consideration because it was not made out of natural love and affection. *(Rajlakhi Devi* vs *Bhootnath)*[20]

2. **Agreement to compensate for past voluntary service** [Sec.25 (2)]. A promise made without consideration is also valid, if it is a promise to compensate, wholly or in part, a person who has already voluntarily done something for the promisor, or done something which the promisor was legally compellable to do.

ILLUSTRATIONS. (*a*) *A* finds *B*'s purse and gives it to him. *B* promises to give *A* Rs 50. This is a contract.[21]

(*b*) *A* supports *B*'s infant son. *B* promises to pay *A*'s expenses in so doing. This is a contract.[21] (Note that *B* was legally bound to support his infant son).

(*c*) *A* rescued *B* from drowning in the river, and *B*, appreciating the service that has been rendered, promises to pay Rs 1,000 to *A*. There is a contract between *A* and *B*.

In order to attract this exception, the following points should be noted:

[18]Illustration appended to Section 25.

[19]6 Mad. 71.

[20](1900), 4, C.W.N.488.

[21]Illustration appended to Section 25.

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(*i*) The service should have been rendered *voluntarily* for the promisor. If it is not voluntary but rendered at the desire of the promisor, then it is covered under 'past consideration' [as per Sec. 2(d)] and not under this exception.

(*ii*) The promisor must be in existence at the time the service was rendered. Thus where services were rendered by a promoter for a company not then in existence, a subsequent promise by the company to pay for them could not be brought within the exception. (*Ahmedabad Jubilee Spinning Co.* vs *Chhotalal*[22]).

(*iii*) The promise must be to compensate a person who has *himself* done something for the promisor and not to a person who has done nothing for the promisor. Thus, where *B* treated *A* during his illness but refused to accept payment from *A*; they being friends; and *A* in gratitude promises to pay Rs 1.000 to *B*'s son *D*, the agreement between *A* and *D* is void for want of consideration as it is not covered under the exception.

(*iv*) The intention of the promisor ought to be to compensate the promisee. A promise given for any motive other than the desire to compensate the promisee would not fall within the exception. (*Abdulla Khan* vs *Parshottam*[23])

(*v*) The promisor to whom the service has been rendered need not be competent to contract at the time the service was rendered. Thus a promise made after attaining majority to pay for goods supplied voluntarily to the promisor during his minority has been held valid and the promisee could enforce it (*Karam Chand* vs *Basant Kaur*[24]). The court in that case observed that they failed to see how an agreement made by a person of full age to compensate wholly or in part a promisee, who had already voluntarily done something for the promisor, even at a time when the promisor was a minor, did not fall within the purview of Sec. 25(2) of the Contract Act. The reasoning of the court is, that at the time the thing was done the minor was unable to contract, and therefore the person who did it for the minor must in law be taken to have done it voluntarily. In their opinion the provisions of Sec. 25(2) applied equally to a contract by a major, as well as by a minor, to pay for past services. In this connection it is important to note that this exception does not cover a promise by a person on attaining majority to repay the money borrowed during his minority because such a promise cannot be said a promise *to compensate* a person who has already *voluntarily* (without any promise of compensation) *done something for the promisor.* 'Advancing money as a loan' necessarily implies a promise to

[22](1908), 10 Bom. L.R. 141.
[23](1948), A.I.R. Bom. 265.
[24](1911), 31 Punj. Rep. 1911. See also *Ram Ratan* vs *Basant Rai*, (1921) 2 Lah.

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compensate (*i.e.*, a promise to repay the loan) on the part of the borrower. Thus a promise made by a minor after attaining majority to repay money advanced during his minority has been held invalid and beyond the purview of Section 25(2) of the Contract Act (*Indran Ramaswami* vs *Anthappa*[25]).

(*vi*) The service rendered must also be legal. Thus past cohabitation will not make a promise to pay for it enforceable under this exception (*Sabava* vs *Yamanappa*[26]).

3. **Agreement to pay a time-barred debt** [Sec. 25 (3)]. Where there is an agreement, made in writing and signed by the debtor or by his authorised agent, to pay wholly or in part a debt barred by the law of limitation, the agreement is valid even though it is not supported by any consideration. A time barred debt cannot be recovered and therefore a promise to repay such a debt is without consideration, hence the importance of the present exception.

But before the exception can apply, it is necessary that:

(*i*) the debt must be such of which the creditor might have enforced payment but for the law for the limitation of suits";[27]

(*ii*) the promisor himself must be liable for the debt. So a promissory note executed by a widow in her *personal capacity* in payment of time-barred debt of her husband cannot be brought within the exception (*Pestonji* vs *Maherbai*[28]);

(*iii*) there must be an 'express promise to pay' a time barred debt as distinguished from a mere 'acknowledgement of a liability' in respect of a debt. Thus a debtor's letter to his creditor, "I owe you Rs 1,000 on account of my time-barred promissory note" is not a contract. There must be a distinct promise to pay; and

(*iv*) the promise must be in writing and signed by the debtor or his agent. An oral promise to pay a time-barred debt is unenforceable.

The logic behind this exception is that by lapse of time the debt is not destroyed but only the remedy is lost. The remedy is revived by a new promise under the exception.

ILLUSTRATION. *A* owes *B* Rs 1,000, but the debt is barred by the Limitation Act. *A* signs a written promise to pay *B* Rs 500 on account of the debt. This is a contract (Appended to Sec. 25).

4. **Completed gift.** A gift (which is not an agreement) does not require consideration in order to be valid. "As between the donor and the donee, any gift actually made will be valid and binding even though without

[25](1906), 16 Mad. L.J. 422. See also *Suraj Narain* vs *Sukhu Ahir*, (1929), 51 All. 164 (f.B.).

[26]35 Bom. L.R. 345. see also *Hussenally* vs *Dinbai*, 26 Bom. L.R. 252.

[27]Section 25 (3).

[28](1928), Bom. L.R. 1407.

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consideration" [Explanation 1, to Section 25]. In order to attract this exception there need not be natural love and affection or nearness of relationship between the donor and donee. The gift must, however, be complete.

5. **Contract of agency.** Section 185 of the Contract Act lays down that no consideration is necessary to create an agency.

6. **Remission by the promisee, of performance of the promise** (Sec. 63). For compromising a due debt, *i.e.*, agreeing to accept less than what is due, no consideration is necessary. In other words, a creditor can agree to give up a part of his claim and there need be no consideration for such an agreement. Similarly, an agreement to extend time for performance of a contract need not be supported by consideration (Sec.63).

7. **Contribution to charity.** A promise to contribute to charity, though gratuitous, would be enforceable, if on the faith of the promised subscription, the promisee takes definite steps in furtherance of the object and undertakes a liability, to the extent of liability incurred, not exceeding the promised amount of subscription. In *Kedar Nath* vs *Gorie Mohammad,*[29] the defendant had agreed to subscribe Rs 100 towards the construction of a Town Hall at Howrah. The plaintiff (secretary of the Town Hall) on the faith of the promise entrusted the work to a contractor and undertook liability to pay him. The defendant was held liable. But where the promisee had done nothing on the faith on the promise, a promised subscription is not legally recoverable. Accordingly, in *Abdul Aziz* vs *Masum Ali,*[30] the defendant promised to subscribe Rs 500 to a fund started for rebuilding a Mosque but no steps had been taken to carry out the repairs. The defendant was held not liable and the suit was dismissed.

TEST QUESTIONS

1. Define consideration. How far is it necessary for the validity of a contract. Critically discuss the essential elements of consideration.

2. Explain the term consideration and state the exceptions to the rule — 'No consideration, no contract.'

3. "Insufficiency of consideration is immaterial; but an agreement without consideration is void". Explain.

4. "A stranger to a contract cannot sue." Discuss. Are there any exceptions to this rule?

5. "A stranger to the consideration can sue but a stranger to contract cannot sue." Explain.

6. "Consideration need not be adequate but it must have some value in the eye of law." Explain.

7. "No consideration, no contract." Explain.

[29](1886), I.L.R. 14 Cal. 64. Also see *Perumal Mudaliar* vs *Sendanatha Mudaliar* (1918), A.I.R. Mad. 311.

[30](1914), A.I.R. All. 22. Also see *Gopal* vs *Trimbak,* (1953), A.I.R. Nag. 195

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PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *M* offered a reward to anyone who would rescue his wife dead or alive from a burning building. A fireman risking his life brought out the wife's dead body. Is he entitled to recovery of the reward?

[**Hint.** Yes. In the instant case the fireman took an *extra risk* of endangering his life, which does not fall in his normal duties in connection with rescue operations. As such the consideration is not illusory and the fireman is entitled to reward.]

2. *A* and *B* are friends. *B* treats *A* during *A*'s illness. *B* does not accept payment from *A* for the treatment and *A* promises *B*'s son, *X*, to pay him Rs 1,000. *A* being in poor circumstances, is unable to pay. *X* sues *A* for the money. Can *X* recover?

[**Hint.** No, *X* cannot recover the money from *A*. The agreement between *X* and *A* is not a contract in the absence of consideration. In this case *X*'s father, *B*, *voluntarily* treats *A* during his illness. Apparently it is not a valid consideration because it is voluntary, whereas consideration to be valid must be given at the desire of the promisor—vide Section 2(d). The question now is whether this case is covered by the exception given in Section 25(2) which *inter-alia* provides: "If it is a promise to compensate a person who has already voluntarily done something for the promisor..." Thus as per the exception the promise must be to compensate a person who has *himself* done something for the promisor and not to a person who has done nothing for the promisor. As *B*'s son, *X*, to whom the promise was made, did nothing for *A*, so *A*'s promise is not enforceable even under the exception.]

3. *X* promised *Y*, his nephew, a reward of Rs 1,000 if he refrained from smoking for two years. *Y* does so. Is he entitled to the reward?

[**Hint.** Yes, *Y* is entitled to the reward from his uncle. In the instant case, *Y* at the desire of *X* refrained from smoking for two years. This is a valid consideration in the form of an act of abstinence—vide Section 2(d).]

4. A writes to *B*, "at the risk of your own life, you saved me from a serious motor accident. I promise to pay you Rs 1,000." A does not pay. Advise *B* as to his legal rights.

[**Hint.** *B* is advised to file a suit for recovery for Rs 1,000. Under Section 25 (2) of the Contract Act, a promise to compensate for voluntary acts done in the past is valid even though without consideration. As the instant case is fully covered by the above Section, *A* cannot avoid his liability later on.]

5. For a valid consideration from *B*, *A* makes a promise to *B* to render some service to *C*. *C* sues *A* on the promise. Discuss whether he can succeed?

[**Hint.** *C* cannot succeed. The general rule of law is that "a stranger to a contract cannot sue." In the instant case, *C* is not a party to the contract and therefore he cannot enforce the promise.]

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Chapter 4

Capacity of Parties

An essential ingredient of a valid contract is that the contracting parties must be 'competent to contract' (Sec.10). Section 11 lays down that "Every person is competent to contract who is of the age of majority according to the law to which he is subject, and who is of sound mind, and is not disqualified from contracting by any law to which he is subject." Thus the Section declares that a person is incompetent to contract under the following circumstances:

I. if he is a minor, according to the law to which he is subject,
II. if he is of unsound mind, and
III. if he is disqualified from contracting by any law to which he is subject.

We shall now discuss them one by one in detail.

I. MINOR

According to Section 3 of the Indian Majority Act 1875, a person, domiciled in India, who is under 18 years of age is a minor. Accordingly every person who has completed the age of 18 years becomes a major. But minors of whose person or property or both a guardian is appointed by a court, and minors of whose property superintendence has been assumed by a Court of Wards,[1] attain majority at the age of 21 years.

Section 11 expressly provides that the age of majority of a person is to be determined "according to the law to which he is subject." The Courts of Law used to decide the age of majority (competency to contract) by the law of domicile and not by the law of the place where the contract is entered into (*Kashiba* vs *Shripat*[2]). But the later trend of law for determining the age of majority is: (*a*) in the case of contracts *relating to ordinary mercantile transactions,* the age of majority is to be determined by the law of the place where the contract is made, and (*b*) in the case of contracts

[1]Under the Court of Wards Act, estates of incompetent persons like minors or lunatics can be placed under the guardianship of the Court of Wards.

[2](1894), 19 Bom. 697.

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relating to land, the age of majority is to be determined by the law of the place where the land is situated (*T.N.S. Firm* vs *Mohd. Hussain*[3]). Thus, where a person aged 18 years, domiciled in India, endorsed certain negotiable instrument in Ceylon, by the laws of which he was a minor,[4] he was held not to be liable as an endorser.

Minor's Agreements

The law regarding minor's agreements may be summed up as under:

1. **An agreement by a minor is absolutely void and inoperative as against him.** Law acts as the guardian of minors and protects their rights, because their mental faculties are not mature—they don't possess the capacity to judge what is good and what is bad for them. Accordingly, where a minor is charged with obligations and the other contracting party seeks to enforce those obligations against minor, the agreement is deemed as *void ab-initio.* In the leading case of *Mohori Bibi* vs *Dharmo Das Ghosh,*[5] a minor executed a mortgage for Rs 20,000 and received Rs 8,000 from the mortgagee. The mortgagee filed a suit for the recovery of his mortgage money and for sale of the property in case of default. The Privy Council *held* that an agreement by a minor was *absolutely void* as against him and therefore the mortgagee could not recover the mortgage money nor could he have the minor's property sold under his mortgage.

No restitution except in certain cases. A minor cannot be ordered to make compensation for a benefit obtained under a void agreement, because Sections 64 and 65 of the Contract Act, which deal with restitution, apply only to contracts between competent parties and are not applicable to a case where there is not and could not have been any contract at all (*Kanta Prasad* vs *Sheo Gopal Lal*).[6] The court may, however, in certain cases, while ordering for the cancellation of an instrument, *at the instance of a minor,* require the minor plaintiff to make compensation to the other party to the instrument. This is so as per Section 33[7] of the Specific Relief Act, 1963, which states as follows:

"On adjudging the cancellation of an instrument, the Court may require the party to whom such relief is granted, to restore, so far as may be, any benefit which he may have received from the other party and to make any compensation to him which justice may require."

Thus, the Court will compel restitution by a minor when he is a plain-

[3](1933), A.I.R. Mad. 756.

[4]The majority age is 21 years in Ceylon.

[5](1903), I.L.R. 30 Cal. 539. Also see *Bhim Mondal* vs *Magaram,* (1961), A.I.R. Pat.21.

[6](1904), 26 All. 342.

[7]Formerly Section 41 of the Specific Relief Act, 1877.

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tiff. For example, if a minor sells a house for Rs 50,000 and later on files a suit to set aside the sale on the ground of minority, he may be directed by the Court to refund the purchase money received by him before he can recover possession of the property sold *(Jager Nath Singh* vs *Lalta Prasad*[8]). It may be emphasised that Section 33 of the Specific Relief Act, 1963, is framed so as to afford relief only in a case where the minor himself as plaintiff seeks the assistance of Court and the Section is inapplicable if he happens to be merely a defendant in a suit by the person who dealt with him when he was a minor. This Section is based on the well known principle that "*he who seeks equity must do equity.*"

2. **Beneficial agreements are valid contracts.** As observed earlier, the court protects the rights of minors. Accordingly, any agreement which is of some benefit to the minor and under which he is required to bear no obligation, is valid. In other words, a minor can be a beneficiary *e.g.*, a payee, an endorsee or a promisee under a contract (*Goekda Latcharao* vs *Vishwanadham Bhomayya*[9]). Thus money advanced by a minor can be recovered by him by a suit because he can take benefit under a contract. The Hindu Minority and Guardianship Act, 1956, also provides to the same effect, namely, a natural guardian is empowered to enter into a contract on behalf of the minor and the contract would be binding and enforceable if the contract is for the benefit of the minor.

ILLUSTRATIONS. (*a*) A duly executed transfer by way of sale or mortgage in favour of a minor, who has paid the whole of the consideration money, is enforceable by him or by any other person on his behalf (*Raghava Chariar* vs *Srinivasa*[10]).

(*b*) Where a minor purchaser of immovable property was, subsequent to his purchase, dispossessed by a third party, it was held that the minor could recover from his vendor the sum which he has paid as purchase money (*Walidad Khan* vs *Janak Singh*).[11]

(*c*) A minor purchaser of immovable property was held entitled to recover possession of property purchased from his vendor, when refused by vendor (*Collector of Meerut* vs *Hardian).*[12]

(*d*) A promissory note executed in favour of a minor is valid and can be enforced in a court (*Sharaft Ali* vs *Noor Mohd.*)[13]

(*e*) Where a minor had performed his part of the agreement and delivered the goods, he was held entitled to maintain a suit for the recovery of their price (*Abdul Gafar* vs *Piare Lal*[14]).

[8](1909), 31 All. 21.
[9](1956), 33 All. 667.
[10](1917), 40 Mad. 308 (F.B.).
[11](1913), 85 All. 370.
[12](1945), A.I.R. All. 156.
[13](1924), A.I.R. Rang. 136.
[14](1935), 16 Lah. 1.

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Contracts of apprenticeship and service by a minor. A contract of apprenticeship stands on a different footing than an agreement of service by a minor. A contract of apprenticeship is valid and binding upon a minor because such a contract is protected by the Apprentices Act, 1961, provided the case falls within the terms of that Act. The Act, *inter alia,* provides that the minor must not be less than fourteen years of age and the contract must be entered into on behalf of the minor by his guardian. The Act was passed with a view to enabling children to learn trades, crafts and employments, by which, when they come to full age, they may gain a livelihood. So far as an agreement of service by a minor is concerned, it is void because a minor's promise to serve would supply no consideration for the promise of the defendant to pay him/her a salary (*Raj Rani* vs *Prem Adib*[15]). In that case the court said that the contract of apprenticeship entered into by the guardian is protected by the Apprentices Act provided the case falls within the terms of that Act, but no such exception is made in the case of contracts of service ... Of course, where a minor has already served under a contract of service, he is entitled to enforce the contract not by virtue of the contract but by reason of the relationship resembling those created by the contract (*i.e.*, by reason of a quasi-contract) under Section 70 of the Contract Act.

3. **No ratification on attaining the age of majority.** Ratification means the subsequent adoption and acceptance of an act or agreement. A minor's agreement being a nullity and void *ab-initio* has no existence in the eye of law. It cannot be ratified by the minor on attaining the age of majority, for, an agreement void *ab-initio* cannot be made valid by subsequent ratification (*Mohendra* vs *Kailash*).[16] "The consideration which passed under the earlier contract cannot be implied into the contract into which the minor enters on attaining majority" (*Nazir Ahmed* vs *Jiwan Dass).*[17] In *Arumugam Chetti* vs *Duraisinga Tevar,*[18] it was held that there can be no ratification of a transaction which is void owing to the promisor possessing no contractual capacity at the time. Nor can a void deed form a good consideration for a fresh contract made by the minor on attaining majority. Similarly, in *Suraj Narain* vs *Sukhu Ahir,*[19] where a minor borrowed a sum of money by executing a promissory note, and after attaining majority executed a second bond in respect of the original loan, the court held that a suit upon the second bond was not maintainable as that bond was without consideration. Since ratification relates back to the date when the

[15](1948), 51 Bom. L.R. 256.
[16](1927), 555 Cal. 841.
[17](1938), A.I.R. Lah. 159.
[18](1914), 37 Mad. 38.
[19](1928), I.L.R. 51 All. 164. Also see *Bindeshri Bakhsh Singh* vs *Chandika Prasad,* (1927), 49 All. 137.

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contract was originally made, it is necessary for a valid ratification that the person who purports to ratify must be competent to contract at the time of the contract. But if services are rendered or an advance is made to a minor during his minority and the services are continued or a further advance is made after he attains majority, a promise to pay for such services or amount *as a whole* would be valid and enforceable *(Sindha* vs *Abraham*[20]).

4. **The rule of estoppel does not apply to a minor.** Section 115 of the Indian Evidence Act explains "Estoppel" as follows: "Where one person has, by his declaration, act or omission, intentionally caused or permitted another person to believe a thing to be true and to act upon such belief, neither he nor his representatives shall be allowed, in any suit or proceeding between himself and such person or his representative, to deny the truth of that thing." In the words of Lord Halsbury: "Estoppel arises when you are precluded from denying the truth of anything, which you have represented as a fact, although it is not a fact." The rule of estoppel does not apply to a minor *i.e.*, a minor is not estopped from pleading his infancy in order to avoid a contract, even if he has entered into an agreement by falsely representing that he was of full age (*Sadiq Ali Khan* vs *Jai Kishore*[21]). In other words, where an infant represents fraudulently or otherwise that he is of full age and thereby induces another to enter into a contract with him, then in an action founded on the contract, the infant is not estopped from setting up infancy.

But if any thing is traceable in the hands of minor, out of the proceeds of the contract made by fraudulently representing that he was of full age, the court may direct the minor to restore that thing to the other party, on *equitable considerations,* for 'minors can have no privilege to cheat man' (*Khan Gul* vs *Lakha Singh*[22]). "... Whenever the infant is still in possession of any property in specie which he has obtained by his fraud, he will be made to restore it to its former owner. But I think that it is incorrect to say that he can be made to repay money which he has spent, merely because he received it under a contract induced by his fraud" (*Lawrence J., in Leslie* vs *Sheill*[23]). Similarly, the infant will be made to restore to the person deceived, any property purchased out of, or money received as a result of, sale proceeds of the goods obtained by his fraud (*Stocks* vs *Wilson*[24]). Thus, if a minor obtains a loan by fraudulent representation and purchases a motorcar out of that, although the loan transaction is invalid, the court may direct the minor to restore the motorcar to the lender. But once the identity

[20](1895), 20 Bom. 755.
[21](1928), 30 Bom. L.R. 1342 (P.C.).
[22](1928), 9 Lah. 701.
[23](1914), 3 K.B. 607.
[24](1913), 2 K.B. 235.

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of the property or money has been lost because it has been spent wastefully, it is no longer possible to invoke the aid of the 'equitable doctrine of restitution'. Again, it may be noted that restoration is allowed only when a minor commits fraud by misrepresenting his age because Section 65 expressly prohibits restoration in cases which are known to be void.

5. **Minor's liability for necessaries.** The case of necessaries supplied to a minor is governed by Section 68 of the Contract Act which provides that "if a person, incapable of entering into a contract, or any one whom he is legally bound to support, is supplied by another person with necessaries suited to his condition in life, the person who has furnished such supplies is entitled to be reimbursed from the property of such incapable person."

ILLUSTRATIONS. (*a*) *A* supplies *B*, a lunatic, with necessaries suitable to his condition in life. *A* is entitled to be reimbursed from *B*'s property.[25]

(*b*) *A* supplies the wife and children of *B*, a lunatic, with necessaries suitable to their condition in life. *A* is entitled to be reimbursed from *B*'s property.[25]

Thus, Section 68 confers a quasi-contractual right on the supplier of "necessaries" to a person incapable of entering into a contract, or to any one whom he is legally bound to support. But a minor is not personally liable, it is his property only which is liable. Therefore if a minor owns no property, the supplier will lose the price of necessaries. Even where a minor owns property, the supplier will get a reasonable price and not the price agreed to by the minor.

"What is a necessary article," is to be determined with reference to the status and circumstances of the particular minor. Objects of mere luxury are not necessaries, nor are objects, which though of real use, are excessively costly. Food and clothing may be taken as simple examples of necessaries. The necessaries would also include the infant's lodging expense, medical attendance, cost of defending a minor in civil and criminal proceedings. Loans taken by a minor to obtain necessaries also bind him. But where a minor is engaged in trade, contracts entered into by him for trading purposes are not for necessaries and are not binding on him.

6. **Specific performance.** Specific performance means the actual carrying out of the contract as agreed. Since an agreement by a minor is absolutely void, the court will never direct 'specific performance'[26] of such an agreement by him. But a contract entered into, on behalf of a minor, by his guardian or by the manager of his estate, is binding on the minor and can be specifically enforced by or against the minor, provided: (*a*) the

[25]Appended to Section 68.

[26]Where for a breach of contract, damages are inadequate remedy, the guilty party may, if the court so likes, be ordered 'specific performance' *i.e.* to perform the contract specifically (to do as agreed).

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contract is within the authority of the guardian or manager; and (*b*) it is for the benefit of the minor. Thus it was held in *Gujoba Tulsiram* vs *Nilkanth*,[27] that a contract of sale of immovable property by the guardian of minor, for the minor benefit, may be specifically enforced by either party to the contract. Similarly, in *Ramalingam* vs *Babanambal*,[28] it was held that a Hindu minor is bound by a contract entered into by his mother as his guardian for sale of his property. However, a guardian has no power to bind the minor: *(i)* by a contract, for the purchase of immovable property (*Mir Sarwarjan* vs *Fakruddin*[29]), and *(ii)* by a contract of service on his behalf (*Raj Rani* vs *Prem Adib*[30]), and therefore such contracts cannot be specifically enforced by or against the minor.

7. **Minor partner.** A minor being incompetent to contract cannot be a partner in a partnership firm, but under Section 30 of the Indian Partnership Act, he can be admitted to the 'benefits of partnership' with the consent of all the partners by an agreement executed through his lawful guardian with the other partners. Such a minor will have a right to such share of the property or profits of the firm as may be agreed upon and he would have access to and inspect and copy any of the accounts of the firm. The minor cannot participate in the management of the business and shall not share losses except when liability to third parties has arisen but then too upto his share in the partnership assets. He cannot be made personally liable for any obligations of the firm, although he may after attaining majority accept those obligations if he thinks fit to do so.

8. **Minor agent.** A minor can be an agent (Sec. 184). He shall bind the principal by his acts done in the course of such an agency, but he cannot be held personally liable for negligence or breach of duty. Thus in appointing a minor as an agent, the principal runs a great risk.

9. **Minor and insolvency.** A minor cannot be adjudicated an insolvent, for, he is incapable of contracting debts. Even for necessaries supplied to him, he is not personally liable, only his property is liable (Sec. 68).

10. **Contract by minor and adult jointly.** Where a minor and an adult jointly enter into an agreement with another person, the minor has no liability but the contract as a whole can be enforced against the adult (*Jamna Bai* vs *Vasanta Rao*[31]). In *Sain Das* vs *Ram Chand*,[32] where there was a joint purchase by two vendees, one of whom was a minor, it was held that the vendor could enforce the contract against the major vendee.

[27](1958), A.I.R. Bom. 202.
[28](1951), A.I.R. Mad. 431.
[29](1912), 39 Cal. 232.
[30](1948), 51 Bom. L.R. 256.
[31](1916), 39 Mad. 409 (P.C.). [Also see Section 43 of the Contract Act.]
[32](1923), 4 Lah. 334.

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11. **Surety for a minor.** Where in a contract of guarantee, an adult stands surety for a minor, the adult is liable under the contract, although the minor is not (as for there is a direct contract between the surety and the third party) (*Kashiba* vs *Shripat*[33]).

12. **Position of minor's parents.** The parents of a minor are not liable for agreements made by a minor, whether the agreement is for the purchase of necessaries or not. The parents can be held liable only when the child is contracting as an agent for the parents.

13. **Minor shareholder.** A minor, being incompetent to contract, cannot be a shareholder of the company. A company can also refuse to register transfer or transmission of shares in favour of a minor unless the shares are fully paid. It follows from it that a minor, acting through his lawful guardian, may become a shareholder of the company, in case of transfer or transmission of fully paid shares to him. Logically also, if a minor could legally hold property in his name, it would be wrong to debar him from holding fully paid up shares in his own name.

14. **Minor's liability in tort.** A 'tort'[34] is a civil wrong (not having its genesis in contractual or equitable relationship) for which the ordinary remedy is damages. A minor is liable for his tort, unless the tort is in reality a breach of contract. Thus, where a minor hired a horse for riding and injured it by over-riding, he was not held liable (*Jennings* vs *Rundall*)[35]. The court observed in that case, "if an infant in the course of doing what he is entitled to do under the contract is guilty of negligence, he cannot be made liable in tort if he is not liable on the contract." But if the wrongful action is of a kind not contemplated by the contract, the minor may be held liable for tort. Thus, where a minor hired a horse for riding under express instructions not to jump, he was held liable when he lent the horse to one of his friends who jumped it, whereby it was injured and ultimately died. The court observed, "... it was a bare trespass, not within the object and purpose of the hiring, for which the defendant was liable" (*Burnard* vs *Haggis*[36]).

II. PERSONS OF UNSOUND MIND

As stated earlier, as per Section 11 of the Contract Act, for a valid contract, it is necessary that each party to it must have a 'sound mind'.

What is a 'sound mind'? Section 12 of the Contract Act defines the

[33](1894), 19 Bom. 697.

[34]"Tort" is, in itself, a very wide field, embracing such diverse conduct as assault, conversion (wrongful use of another's property), defamation, false imprisonment, intimidation, negligence, malicious prosecution, trespass over immovable property, nuisance and so on.

[35](1799), 8 T.R. 335.

[36](1863), 14 C.B. 45.

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term 'sound mind' as follows: "A person is said to be of sound mind for the purpose of making a contract, if, at the time when he makes it, he is capable of understanding it and of forming a rational judgment as to its effects upon his interests."

According to this Section, therefore, the person entering into the contract must be a person who understands what he is doing and is able to form a rational judgment as to whether what he is about to do is to his interest or not. The Section further states that:

(i) "A person who is usually of unsound mind, but occasionally of sound mind, may make a contract when he is of sound mind."Thus a patient in a lunatic asylum, who is at intervals of sound mind, may contract during those intervals.[37]

(ii) "A person who is usually of sound mind, but occasionally of unsound mind, may not make a contract when he is of unsound mind." Thus, a sane man, who is delirious from fever, or who is so drunk that he cannot understand the terms of a contract, or form a rational judgment as to its effect on his interest, cannot contract whilst such delirium or drunkenness lasts.[38]

In *Halsbury's Laws of England,*[39] it is stated: "The general theory of the law in regard to acts done, contracts made by parties affecting their rights and interests, is that in all cases there must be a free and full consent to bind the parties. Consent is an act of reason accompanied by deliberation, and it is upon the ground that there is a want of rational and deliberate consent that the conveyance and contracts of unsound mind are generally deemed to be invalid; or in other words, (subject to exceptions), there cannot be a contract by a person of unsound mind."

Unsoundness of mind may arise from: (*a*) *Idiocy*—It is God given and permanent, with no intervals of saneness. The mental powers of an idiot are completely absent because of lack of development of the brain; (*b*) *Lunacy or Insanity*—It is a disease of the brain. A lunatic loses the use of his reason due to some mental strain or disease. Of course he may have lucid intervals of sanity; *(c) Drunkenness*—It produces temporary incapacity, till the drunkard is under the effect of intoxication, provided it is so excessive as to suspend the reason for a time and create impotence of mind; *(d) Hypnotism*—It also produces temporary incapacity, till the person is under the impact of artificially induced sleep; *(e) Mental decay* on account of old age, *etc.* In cases where the contract is sought to be avoided on any of the above grounds, the burden of proof lies on the party who sets up such a disability; but if unsoundness of mind is once established, the burden of

[37]Illustration (*a*) to Section 12.
[38]Illustration (*b*) to Section 12.
[39]2nd. ed., V. 21, pp. 279-80.

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proving a lucid interval is on him, who sets it up (*Mohanlal* vs *Vinayak*).[40]

Effects of agreements made by persons of unsound mind. An agreement entered into by a person of unsound mind is treated on the same footing as that of minor's, and therefore an agreement by a person of unsound mind is absolutely void and inoperative as against him but he can derive benefit under it (*Jugal Kishore* vs *Cheddu*[41]). The property of a person of unsound mind is, however, always liable for necessaries supplied to him or to any one whom he is legally bound to support, under Section 68 of the Act.[42]

III. DISQUALIFIED PERSONS

The third type of incompetent persons, as per Section 11, are those who are "disqualified from contracting by any law to which they are subject." Thus:

(a) **Alien enemies.** An alien (citizen of a foreign country) living in India can enter into contracts with citizens of India during peace time only, and that too subject to any restrictions imposed by the Government in that respect. On the declaration of a war between his country and India, he becomes an alien enemy and cannot enter into contracts. "Alien friend can contract but an alien enemy can't contract." Contracts entered into before the declaration of the war stand suspended and cannot be performed during the course of war, of course, they can be revived after the war is over provided they have not already become time-barred.

(b) **Foreign sovereigns and ambassadors.** One has to be cautious while entering into contracts with foreign sovereigns and ambassadors, because whereas they can sue others to enforce the contracts entered upon with them, they cannot be used without obtaining the prior sanction of the Central Government. Thus they are in a privileged position and are ordinarily considered incompetent to contract.

(c) **Convict.** A convict is one who is found guilty and is imprisioned. During the period of imprisonment, a convict is incompetent *(a)* to enter into contracts, and *(b)* to sue on contracts made before conviction. On the expiry of the sentence, he is at liberty to institute a suit and the Law of Limitation is held in abeyance during the period of his sentence.

(d) **Married women.** Married women are competent to enter into contracts with respect to their separate properties (*Stridhan*) provided they are major and are of sound mind. They cannot enter into contracts with respect to their husbands' properties. A married woman can, however, act as an

[40](1941), A.I.R. Nag. 251.

[41](1903), 1 All. L.J. 43.

[42]For a detailed study, refer to the heading *'Minor's Agreements'* already discussed in the present chapter.

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agent of her husband and bind her husband's property for necessaries supplied to her, if he fails to provide her with these.

(e) **Insolvent.** An adjudged insolvent (before an 'order of discharge') is competent to enter into certain types of contracts *i.e.,* he can incur debts, purchase property or be an employee but he cannot sell his property which vests in the Official Receiver. Before 'discharge' he also suffers from certain disqualifications *e.g.,* can't be a magistrate or a director of a company or a member of local body but he has the contractual capacity except with respect to his property. After the 'order of discharge,' he is just like an ordinary citizen.

(f) **Joint-stock company and corporation incorporated under a special Act** (like L.I.C., U.T.I.). A company/Corporation is an artificial person created by law. It cannot enter into contracts outside the powers conferred upon it by its Memorandum of Association or by the provisions of its special Act, as the case may be. Again, being an artificial person (and not a natural person) it cannot enter into contracts of a strictly personal nature *e.g.,* marriage.

TEST QUESTIONS

1. What do you understand by 'capacity to contract'? What is the effect of agreements made by persons of unsound mind?
2. Discuss in detail the provisions of law relating to minor's agreements.
3. *(a)* Is a minor bound on his agreement for necessaries? Is he liable upon a bill of exchange which he has accepted in payment for necessaries?

(b) Can a promise by a person on attaining majority to repay money lent and advanced to him during his minority be enforced?

4. Discuss with suitable illustrations the law relating to validity of contracts by minors.
5. "Apart from minority and unsoundness of mind, the capacity of a person may be affected by virtue of any special law to which he is subject." Comment on the statement.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A,* an infant, obtains a loan from *B.* Can *A* be asked to repay the money?

[**Hint.** No, *A* cannot be asked to repay the money. A minor's agreement is void *ab-initio* as against him (*Mohori Bibi* vs *Dharmodas Ghosh*).]

2. *A,* a minor lends Rs 1,000 against a Promissory Note executed in his favour. Is the borrower liable to repay the money?

[**Hint.** Yes, the borrower is liable to repay the money to the minor, because the law protects the rights of minors *i.e.,* a minor can take benefit under a contract *e.g.,* he can be a payee or a promisee.]

3. A minor fraudulently represented to a moneylender that he was of full age, and obtained a loan of Rs 500. Has the moneylender any right of action against the

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minor for the money lent, or for damages for fraudulent misrepresentation?

[**Hint**. No, the moneylender does not have any right of action against the minor on either of the grounds, because the 'Rule of Estoppel' does not apply to a minor. Of course, if any thing is traceable in the hands of the minor out of the amount of loan so obtained, the court may direct the minor to restore that thing to the other party, on equitable consideration, for, 'minors can have no privilege to cheat man.']

4. *A*, an infant, borrows Rs 2,000 from *B* and executes a promissory note for the amount in favour of *B*. On his attaining majority, the minor executes another promissory note in lieu of the first which is then cancelled. Is the second promissory note valid?

[**Hint**. The second promissory note is invalid, for a minor's agreement, being void *ab-initio*, cannot be made valid by subsequent ratification (*Mohindra* vs *Kailash*).]

5. *A* renders some service to *B* during his minority at the request of *B*. *B*, on attaining majority, enters into an agreement with *A* to compensate *A* for services rendered during *B*'s minority. Is the agreement valid?

[**Hint**, Yes, the agreement is valid and the promisee could enforce it, as it is covered within the purview of the exception to 'consideration' as given in Section 25(2) (*Karam Chand* vs *Basant Kaur*). (For clear understanding refer to Chapter 3—Side Heading: "No Consideration Necessary," Para Heading: "Agreement to compensate for past voluntary service").]

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Chapter 5

Free Consent

It has already been pointed out in Chapter 1 that, according to Section 10, 'free consent' of all the parties to an agreement is one of the essential elements of a valid contract.

'Consent' defined. Section 13 of the Contract Act defines the term 'consent' and lays down that "Two or more persons are said to consent when they agree upon the same thing in the same sense."Thus, consent involves identity of minds or *consensus ad-idem i.e.,* agreeing upon the same thing in the same sense. If, for whatever reason, there is no *consensus ad-idem* among the contracting parties, there is no real consent and hence no valid contract.

'Free Consent' defined. Section 14 lays down that "Consent is said to be 'free' when it is *not caused* by

1. *coercion,* as defined in Section 15, *or*
2. *undue influence,* as defined in Section 16, *or*
3. *misrepresentation,* as defined in Section 18, *or*
4. *fraud,* as defined in Section 17, *or*
5. *mistake,* subject to the provisions of Sections, 20, 21 and 22."

"Consent is said to be *so caused* when it would not have been given but for the existence of such coercion, undue influence, misrepresentation, fraud or mistake" (Sec. 14). This means that in order to bring a case within this Section, the party, who alleges that his consent has been caused by any of the above elements which vitiate consent, must show that, but for the vitiating circumstance the agreement would not have been entered into. To put it differently, in order to prove that his consent is 'not free,' the complainant must prove that if he had known the truth, or had not been forced to agree, he would not have entered into the contract.

In the absence of 'free consent', the contract may turn out to be either voidable or void depending upon the nature of the flaw in consent. When consent to an agreement is caused by coercion, undue influence, misrepresentation or fraud, there is 'no free consent' and the contract is voidable at the option of the party whose consent was so caused (Secs. 19 and 19A).

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But when consent is caused by 'bilateral mistake'[1] as to a matter of fact essential to the agreement, the agreement is void (Sec.20). In such a case there is 'no consent' at all.

The various causes leading to 'flaw in consent' will now be discussed one by one in detail.

COERCION

Definition

Section 15 of the Contract Act defines 'Coercion' as follows:

"Coercion is the committing or threatening to commit, any act forbidden by the Indian Penal Code, or the unlawful detaining or threatening to detain, any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement."

The **Explanation** to the Section further adds that "it is immaterial whether the Indian Penal Code is or is not in force in the place where the coercion is employed."

The above definition can be analysed as follows:

1. Coercion implies *(a)* committing or threatening to commit any act forbidden by the Indian Penal Code;[2] *or (b)* unlawful detaining or threatening to detain any property, with the intention of causing any person to enter into an agreement.

ILLUSTRATIONS. *(i)* A Madrasi gentleman died leaving a young widow. The relatives of the deceased threatened the widow to adopt a boy otherwise they would not allow her to remove the dead body of her husband for cremation. The widow adopted the boy and subsequently applied for cancellation of the adoption. It was held that her consent was not free but induced by coercion, as any person who obstructed a dead body from being removed for cremation, would be guilty of an offence under Section 297 of the I.P.C. The adoption was set aside (*Ranganayakamma* vs *Alwar Setti*[3]).

(ii) *L* threatens to shoot *M*, if he does not let out his house to him. *M* agrees to let out his house to *L*. The consent of *M* has been induced by coercion.

(iii) An agent refused to hand over the account books of the business to the new agent sent in his place, unless the Principal released him from all liabilities. The Principal had to give a release deed as demanded. *Held,* that the release deed was voidable at the instance of the Principal who was made to execute the release deed under coercion (*Muthia* vs *Karuppan*[4]).

[1]For a detailed discussion, refer to the heading '*Mistake*' dealt later in this chapter.

[2]Threat to shoot, murder, intimidation, threat to cause hurt, rape, defamation, giving wrong evidence, instigating to commit crime, theft, attempt to commit suicide, are a few examples of acts forbidden by Indian Penal Code.

[3](1889), 13 Mad. 214.

[4](1927), 50 Mad. 786.

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(iv) The Government gave a threat of attachment against the property of *A* , for the recovery of a fine due from *B*, the son of *A*. *A*, paid the fine. *Held*, the payment of fine was induced by coercion and therefore *A* was entitled to recover the moneys paid to remove wrongful attachment (*Bansraj* vs *The Secy. of State*[5]).

2. The act constituting coercion, may be directed at any person, and not necessarily at the other party to the agreement. Likewise it may proceed even from a stranger to the contract.

ILLUSTRATIONS. *(a) A*, threatens to shoot *B*, a friend of *C* if *C* does not let out his house to him. *C* agrees to do so. The agreement has been brought about by coercion.

(b) A, threatens to shoot *B* if he does not let out his house to *C*. *B* agrees to let out his house to *C*. *B*'s consent has ben caused by coercion.

3. It does not matter whether the Indian Penal Code is or is not in force in the place where the coercion is employed. If the suit is filed in India, the above provision (*i.e.*, Sec. 15) will apply.

ILLUSTRATION (Appended to Sec. 15). *A*, on board an English ship on the high seas, causes *B* to enter into an agreement by an act amounting to criminal intimidation under the Indian Penal Code. *A*, afterwards sues *B* for breach of contract at Calcutta. *A*, has employed coercion, although his act is not an offence by the law of England and although Section 506 of the Indian Penal Code was not in force, at the time when, or place where, the act was done.

Threat to file a suit. To threaten a criminal or civil prosecution does not constitute coercion because it is not an act forbidden by the Indian Penal Code. But a threat to file a suit on a *false charge* constitutes coercion, for such an act is forbidden by the I.P.C. (*Askari Mirza* vs *Bibi Jai Kishori*[6]).

Threat to commit suicide. Neither '*suicide*' nor '*threat to commit suicide*' is punishable under the Indian Penal Code; only '*an attempt to commit suicide*' is punishable under it. In *Chikkam Ammiraju* vs *Chikkam Seshamma*,[7] there arose a question as to whether '*a threat to commit suicide*' amounts to coercion, and their Lordships of the Madras High Court answered the question in the affirmative holding that this amounts to coercion. In that case a person, by a threat to commit suicide, induced his wife and son to execute a release deed in favour of his brother in respect of certain properties which they claimed as their own. The transaction was set aside on the grounds of coercion. It was stated by the majority of judges that though 'a threat to commit suicide' was not punishable under the Indian Penal Code, it must be deemed to be *forbidden* by that Code, as 'an attempt to commit suicide' was punishable under Section 309 of that Code. Their Lordships observed: "The term 'any act *forbidden* by the Indian Penal

[5](1939), A.W.R. 247.
[6](1912), 16, I.C. 344.
[7](1918), 41 Mad. 33.

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Code' is wider than the term '*punishable* by the Indian Penal Code.' Simply because a man escapes punishment, it does not follow that the act is not forbidden by the Penal code. For example, a lunatic or a minor may not be punished. This does not show that their criminal acts are not forbidden by the Penal Code."

Duress. The term 'duress' is used in English Law to denote illegal imprisonment *or* either actual or threatened violence over the person (body) of another party or his wife or children with a view to obtain the consent of that party to the agreement. In short, for 'duress' the act or threat must be aimed at the life or liberty of the other party to the contract or the members of his family. A threat to destroy or detain property will not amount to 'duress.' Thus the scope of the term 'coercion,' as defined in Section 15, is wider, because it includes threats over property also.

Effect of Coercion

A contract brought about by coercion is *voidable* at the option of the party whose consent was so caused (Sec. 19). This means that the aggrieved party may either exercise the option to affirm the transaction and hold the other party bound by it, or repudiate the transaction by exercising a right of rescission.[8] As per Section 64, if the aggrieved party opts to rescind a voidable contract, he must restore any benefit received by him under the contract to the other party from whom received.

The burden of proof that coercion was used lies on the party who wants to set aside the contract on the plea of coercion.

UNDUE INFLUENCE

Definition

Section 16(1) defines the term 'Undue influence' as follows:

"A contract is said to be induced by undue influence where, *(i)* the relations subsisting between the parties are such that one of the parties is *in a position to dominate the will of the other,* and *(ii)* he uses the position to obtain an unfair advantage over the other."

The phrase "in a position to dominate the will of the other" is clarified by the same Section under sub-section (2), thus:

Section 16(2). A person is deemed to be in a position to dominate the will of another—

(a) where he holds a real or apparent authority over the other, *e.g.,* the relationship between master and the servant, police officer and the accused; or

[8]The power to rescind the contract is lost in certain cases. For details refer to the heading '*Loss of Right of Rescission*' discussed later in this chapter.

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(b) where he stands in a fiduciary relation to the other. Fiduciary relation means a relation of mutual trust and confidence. Such a relationship is supposed to exist in the following cases: father and son, guardian and ward, solicitor and client, doctor and patient, Guru (spiritual adviser) and disciple, trustee and beneficiary, *etc.*; or

(c) where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness, or mental or bodily distress, *e.g.,* old illiterate persons.

It is to be observed that for proving the use of undue-influence both the elements mentioned above, *namely, (i)* the other party was in a position to dominate his will, and *(ii)* the transaction was an unfair one, must be established.

Presumption of Undue Influence

Undue influence is presumed to exist under the circumstances mentioned above in sub-clauses *(a)*, *(b)* and *(c)*. In other words, for example, where the relationship between the contracting parties is that of master and servant, father and son, doctor and patient, solicitor and client, *etc.,* or where one of the parties to the contract is an old illiterate person, there is no need of proving the use of undue influence by the party whose consent was so caused. Merely status of parties is enough to prove the existence of undue influence in these cases. Presumption of undue influence is also there, in case of a contract by or with a 'pardanashin woman.'[9]

There is, however, no presumption of undue influence in the following cases:

(i) Husband and wife (In case of persons engaged to marry, the presumption of undue influence will arise).[10]

(ii) Mother and daughter.[11]

(iii) Grandson and grandfather.[12]

(iv) Landlord and tenant.[13]

(v) Creditor and debtor.[14]

In these cases, undue influence shall have to be proved by the party alleging that undue influence existed.

Burden of proof and rebutting the presumption. In cases where there is a presumption of undue influence the burden of proving that the person

[9]Also see the heading '*pardanashin woman*' dealt later in this chapter.
[10]*Sar Farazali* vs *Ahmad Kamil,* A.I.R. (1944), All. 104.
[11]*Ismail* vs *Hafiz Boo,* (1906), 33 Cal. 773.
[12]*Lakshmi Amma* vs *Telengana Narayana,* A.I.R. (1970), S.C.1367.
[13]*Promoda Nath* vs *Kinoo Mollali,* (1908), 8 Cal. L.J. 135.
[14]For details refer to the heading '*Unconscionable Transactions*' dealt later in this chapter.

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who was in a position to dominate the will of another, did not use his position to obtain an unfair advantage, will lie upon the person who was in a position to dominate the will of the other [Sec. 16 (3)]. He can rebut or oppose the presumption by arguing *(i)* that full disclosure of facts was made, *(ii)* that the price was adequate, *(iii)* that the other party was in receipt of competent independent advice and his consent was free.

ILLUSTRATIONS. *(a) A,* having advanced money to his son *B,* obtains, by misuse of parental influence, a bond from *B* for a greater amount than the sum due in respect of the advance. *A* employs undue influence. As undue influence is presumed to exist if the relationship between contracting parties is that of father and son, the burden of proof lies on *A,* the father. It will be for *A* to prove that he did not employ undue influence, on a suit by *B* alleging undue influence.

(b) A, a man enfeebled by disease or age, is induced, by *B*'s influence over him as his medical attendant, to agree to pay *B* an unreasonable sum for his professional services. *B* employs undue influence.[15] On a petition by *A* alleging undue influence, it lies on *B,* the doctor, to prove that the contract was not induced by undue influence.

(c) An old illiterate woman made a gift of almost the whole of her property to her nephew, who was managing her estate. On a petition by the old lady for setting aside the gift deed on the ground of undue influence, the onus lies on the nephew to prove that the transaction is *bona fide,* well understood and free from undue influence, because undue influence is presumed in such a case.

Effect of Undue Influence

"When consent to an agreement is caused by undue influence, the agreement is a contract voidable at the option of the party whose consent was so caused. Any such contract may be set aside either absolutely or, if the party who was entitled to avoid it has received any benefit thereunder, upon such terms and conditions as the court may seem just." (Sec. 19-*A*)

ILLUSTRATIONS (Appended to Sec. 19-A). (*a*) *A*'s son has forged *B's* name to a promissory note. *B,* under threat of prosecuting *A's* son, obtains a bond from *A* for the amount of the forged note. If *B* sues on this bond, the Court may set the bond aside.

(*b*) *A*, a money lender, advances Rs 100 to *B,* an agriculturist, and by undue influence, induces *B* to execute a bond for Rs 200 with interest at 6 per cent per month. The Court may set the bond aside, ordering *B* to repay the Rs 100 with such interest as may seem just.

Thus, it will be noticed that Section 19-*A* also declares a contract brought about by undue influence *voidable* at the option of the aggrieved party, just as Section 19 so declares in case of a contract brought about by coercion, misrepresentation or fraud. *The special feature of Section 19-A* is that while in the case of rescission of a contract procured by coercion,

[15]Illustration appended to Section 16.

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misrepresentation or fraud, any benefit received by the aggrieved party has to be restored under Section 64 of the Contract Act; under Section 19-*A*, if a contract procured by undue influence is set aside,[16] the Court has *discretion* to direct the aggrieved party for refunding the benefit whether in whole or in part or set aside the contract without any direction for refund of benefit.

The following points must also be noted in this connection:

(*i*) Lack of judgment, lack of knowledge of facts or absence of foresight are generally not by themselves sufficient reasons for setting aside a contract on the ground of undue influence. Persuation and argument are also not in themselves undue influence. Undue influence implies mental and moral coercion so as to make the consent of one of the parties to the contract unfree.

(*ii*) Undue influence by a person, who is not a party to the contract, may make the contract voidable. In other words, it is not necessary that the person in a position to dominate the will of the other party must himself be benefited. It is sufficient if the third person in whom he is interested is benefited (*Chinnamma* vs *Devenga Sangha*[17]).

Unconscionable Transactions

Unfair or unreasonable bargains belong to the category of 'unconscionable transactions.' These are such transactions where as between two contracting parties, one is in a dominant position and makes an exorbitant profit of the other's distress.

High rate of interest. Unconscionable bargains take place mostly in moneylending transactions where moneylenders charge high rates of interest from needy borrowers. The presumption of undue influence on the ground of high rate of interest is raised only when the following two things are proved:

1. that the moneylender was in a position to dominate the will of the borrower, and

2. that the bargain is unreasonable *i.e.*, rate of interest is excessive without any valid reason.

In such cases the law presumes that consent must have been obtained by undue influence and the burden of proving that there was no undue influence lies on the creditor. It must be noted that both the above conditions must be proved for giving rise to a presumption of undue influence. There will be no presumption of undue influence and a transaction will not be set aside on ground of undue influence, merely because the rate

[16]The power to set aside the contract is, however, lost in certain cases. For details refer to the heading — '*Loss of Right of Rescission*' discussed later in this chapter.

[17](1973), A.I.R. Mys. 338.

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of interest is high if both the parties are on equal footing (*i.e.*, none of the parties is in a position to dominate the will of the other party) or if there exists valid reason (like tight money market conditions) for charging high rate of interest.

ILLUSTRATIONS. (*a*) *A*, being in debt to *B*, the moneylender of his village, contracts a fresh loan on terms which appear to be unconscionable. It lies on *B* to prove that the contract was not induced by undue influence [Illustration (*c*) to Section 16].

(*b*) A poor Hindu widow borrowed Rs 1,500 from a moneylender at 100 per cent per annum rate of interest for the purpose of enabling her to establish her right to maintenance. It lies on the moneylender to prove that there was no undue influence (*Rannee Annapurni* vs *Swaminatha*[18]).

(*c*) *A*, applies to a banker for a loan at the time when there is stringency in the money market. The banker declines to make the loan except at an unusually high rate of interest. *A*, accepts the loan on these terms. This is a transaction in the ordinary course of business, and the contract is not induced by undue influence [Illustration (*d*) to Section 16].

Now-a-days, however, drastic legislation in almost every State (fixing maximum rates of interest etc.) has proved greater protection to debtors.

High prices. As regards exorbitant price charged by the trader, it is never considered a case of undue influence.

Pardanashin Woman

As observed earlier, there is a presumption of undue influence in case of a contract by or with a '*pardanashin woman*'. She can avoid any contract entered by her on the plea of undue influence and it is for the other party to prove that no undue influence was used. For proving the absence of undue influence, the other party will have to satisfy the Court (*i*) that the terms of the contract were fully explained to her, (*ii*) that she understood their implications, and was free to have independent advice in the matter, and (*iii*) that she freely consented to the contract. It may be noted that the term 'pardanashin' here refers to a woman who observes *complete seclusion* (parda) from contact with people outside her own family, because of the custom of her community, and one does not become 'pardanashin' simply because she lives in *some degree of seclusion* (*Shaik Ismail* vs *Amir Bibi*[19]). Further, note that the protection granted to pardanashin woman is also extended to illiterate and ignorant ladies, who are equally exposed to the danger and risk of an unfair deal (*Sonia Parshini* vs *S.M. Baksha*[20]).

Distinction between Coercion and Undue Influence

Both, coercion and undue influence, vitiate consent and make the

[18](1910), 34 Mad. 7.
[19](1920), 4 Bom. L.R. 146.
[20](1950), A.I.R. Cal. 17.

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consent of one of the parties to the contract unfree. But the following are the points of distinction between the two:

1. In coercion, the consent of the aggrieved party is obtained by committing or threatening to commit an act forbidden by Indian Penal Code *or* detaining or threatening to detain some property unlawfully. While in undue influence, the consent of the aggrieved party is affected from the domination of the will of one person over another.

2. Coercion is mainly of a physical character involving mostly use of physical or violent force. Whereas undue influence is of moral character involving use of moral force or mental pressure.

3. While in the case of rescission of a contract procured by coercion, any benefit received by the aggrieved party has to be restored under Section 64 of the Contract Act; in the case of rescission of a contract procured by undue influence, as per Section 19-A, the Court has discretion to direct the aggrieved party for restoring the benefit whether in whole or in part or set aside the contract without any direction for refund of benefit.

MISREPRESENTATION

A representation means a statement of fact made by one party to the other, either before or at the time of contract, relating to some matter essential to the formation of the contract, with an intention to induce the other party to enter into the contract. It may be expressed by words spoken or written or implied from the acts or conducts of the parties (*e.g.*, non-disclosure of a fact).

A representation when wrongly made, either innocently or intentionally, is termed as a misrepresentation. To put in differently, misrepresentation may be *either* innocent *or* intentional or deliberate with an intent to deceive the other party. In law, for the former kind, the term 'Misrepresentation' and for the latter the term 'Fraud' is used.

Definition

According to Section 18 'Misrepresentation' means and includes:

(*a*) the positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true; or

(*b*) any breach of duty which, without an intent to deceive, gains an advantage to the person committing it, or any one claiming under him, by misleading another to his prejudice or to the prejudice of any one claiming under him; or

(*c*) causing, however innocently, a party to an agreement, to make a mistake as to the substance of the thing which is the subject of the agreement.

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Thus, as per Section 18, there is misrepresentation in the following three cases:

(*a*) *Positive assertion of unwarranted statements of material facts believing them to be true.* If a person makes an explicit statement of fact not warranted by his information (*i.e.*, without any reasonable ground), under an honest belief as to its truth though it is not true, there is misrepresentation.

ILLUSTRATION. *A* says to *B* who intends to purchase his land, "My land produces 10 quintals of wheat per acre." *A*, believes the statement to be true, although he did not have sufficient grounds for the belief. Later on, it transpires that the land produces only 7 quintals of wheat per acre. This is a misrepresentation.

It may be noted that a mere expression of opinion or words of commendation, for example, in a sale of land a mere general statement that the land is fertile, cannot be held to amount to a positive assertion.

(*b*) *Breach of duty which brings an advantage to the person committing it by misleading the other to his prejudice.* This clause covers those cases where a statement when made was true but subsequently before it was acted upon, it became false to the knowledge of the person making it. In such a case, the person making the statement comes under an obligation to disclose the change in circumstances to the other party, otherwise he will be guilty of misrepresentation.

ILLUSTRATION. *A*, before signing a contract with *B* for the sale of business, correctly states that the monthly sales are Rs 50,000. Negotiations lasted for five months, when the contract of sale was signed. During this period the sales dwindled to Rs 5,000 a month. *A*, unintentionally keeps quite. It was held that there was misrepresentation and *B* was entitled to rescind the contract (*With* vs *O' Flanagan*[21]).

Note, that a partial non-disclosure may also constitute a misrepresentation, for instance, where a vendor of land told a purchaser that all the farms on the land were fully let, but inadvertently omitted to inform him that the tenants had given notice to quit, he was held guilty of misrepresentation (*Dimmock* vs *Hallett*[22]).

(*c*) *Causing mistake about subject-matter innocently.* If one of the parties induces the other, though innocently, to commit a mistake as to the quality or nature of the thing bargained, there is misrepresentation.

ILLUSTRATION. In a contract of sale of 500 bags of wheat , the seller made a representation that no sulphur has been used in the cultivation of wheat. Sulphur, however, had been used in 5 out of 200 acres of land. The buyer would not have purchased the wheat but for the representation. There is a misrepresentation.

[21](1936), Ch. 575.
[22](1866), 2 Ch. App.21.

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Essentials of misrepresentation. From the foregoing discussion, it follows that for alleging misrepresentation, the following four things are necessary:

(*i*) There should be a representation, made innocently, with an honest belief as to its truth and without any desire to deceive the other party, either expressly or impliedly.

(*ii*) The representation must relate to facts material to the contract and not to mere opinion or hearsay.

(*iii*) The representation must be, or must have become untrue.

(*iv*) The representation must have been instrumental in inducing the other party to enter into a contract (As per the Explanation to Section 19).

Effects of Misrepresentation

In case of misrepresentation, the aggrieved party has two alternative courses open to him — (*i*) he can rescind[23] the contract, treating the contract as voidable; or (*ii*) he may affirm the contract and insist that he shall be put in the position in which he would have been, if the representation made had been true (Sec. 19). Misrepresentation does not entitle the aggrieved party to claim damages by way of interest or otherwise for expenses incurred.

ILLUSTRATION. *A,* innocently in good faith tells *B* that his T.V. set is made in Japan. *B,* thereupon buys the T.V. set. However, it comes out to be an Indian make. *A,* is guilty of misrepresentation. *B,* may either avoid the contract or may insist on its being carried out. In the latter case, *B* may either ask for replacing the set by a Japanese make set or may keep the Indian make set and claim the difference in price between that set and a Japanese make set.

Exception. The above remedy is lost, if the party whose consent was caused by misrepresentation, had the means of discovering the truth with ordinary diligence.

ILLUSTRATION. *A,* by a misrepresentation, leads *B* erroneously to believe that 500 maunds of indigo are made annually at *A*'s factory. *B* examines the accounts of the factory, which show that only 400 maunds of indigo have been made. After this *B* buys the factory. The contract is not voidable on account of *A's* misrepresentation (Illustration (*b*) to Section 19].

FRAUD

The term 'fraud' includes all acts committed by a person with an intention to deceive another person.

[23]The power to rescind the contract is, however, lost in certain cases. For details refer to the heading — '*Loss of Right of Rescission*' dealt later in this chapter.

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Definition

According to Section 17, 'fraud means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive or to induce another party thereto or his agent, to enter into the contract:

1. *The suggestion that a fact is true when it is not true by one who does not believe it to be true.* Thus a false statement intentionally made is fraud. An absence of honest belief in the truth of the statement made is essential to constitute fraud. If a representor honestly believes his statement to be true, he cannot be liable in deceit no matter how ill-advised, stupid, or even negligent he may have been. In order to be called fraudulent representation the false statement must be made intentionally. Lord Herschell gave the definition of fraud in *Derry* vs *Peek*[24] as, "a false statement made knowingly, or without belief in its truth, or recklessly careless whether it be true or false."

2. *The active concealment of a fact by a person who has knowledge or belief of the fact.* Active concealment of a material fact is taken as much a fraud as if the existence of such fact was expressly denied or the reverse of it expressly stated. Mere non-disclosure is not fraud, where there is no duty to disclose. *Caveat Emptor* or 'Buyer Beware' is the principle in all contracts of sale of goods. As a rule the seller is not bound to disclose to the buyer the faults in the goods he is selling.

ILLUSTRATIONS. (*a*) *A*, a horse dealer, sells a mare to *B*. *A* knows that the mare has a cracked hoof which he fills up in such a way as to defy detection or on enquiry from *B*, *A* affirms that the mare is sound. The defect is subsequently discovered by *B*. There is 'fraud' on the part of *A* and the agreement can be avoided by *B* as his consent has been obtained by fraud.

(*b*) *A*, sells by auction, to *B* a horse, which he knows to be unsound. *A* says nothing to *B* about the horse's unsoundness. This is not 'fraud' because *A* is under no duty to disclose the fact to *B*, the general rule of law being 'let the buyer beware' [Illustration (*a*) to Section 17].

3. *A promise made without any intention of performing it.* If a man while entering into a contract has no intention to perform his promise, there is fraud on his part.

ILLUSTRATIONS. (*a*) *X* purchases certain goods from *Y* on credit without any intention of paying for them as he was in insolvent circumstances. It is a clear case of fraud from *X*'s side. Note that mere failure to pay, where there was no original dishonest intention, is not fraud.

(*b*) Where a man and a woman went through a ceremony of marriage without any intention on the part of the husband to regard it as a real marriage, it was held that the consent of the wife was obtained by fraud and that the marriage was mere pretence (*Shireen Mal* vs *John J. Taylor*[25]).

[24](1889), 14 A.C. 337.

[25](1952), A.I.R. Punj. 277.

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4. *Any other act fitted to deceive.* "The fertility of man's invention in devising new schemes of fraud is so great that it would be difficult, if not impossible, to confine fraud within the limits of any exhaustive definition. All surprise, trick, cunning, dissembling and other unfair way that is used to cheat anyone is considered fraud and sub-section (4) is obviously intended to cover all those cases of fraud which cannot appropriately be covered by the other sub-sections."[26]

5. *Any such act or omission as the law specially declares to be fraudulent.* This sub-section refers to the provisions in certain Acts which make it obligatory to disclose relevant facts. Thus, for instance, under Section 55 of the Transfer of Property Act, the seller of immovable property is bound to disclose to the buyer all material defects in the property (*e.g.*, the roof has a crack) or in the seller's title (*e.g.*, the property is mortgaged). An omission to make such a disclosure amounts to fraud.

Thus, in order to allege fraud, the act complained of must be brought within the scope of the acts enumerated above. A mere expression of opinion or commendatoy expression is not fraud. "The land is very fertile" is simply a statement of opinion *or* "our products are the best in the market" is merely a commendatory expression. Such statements do not ordinarily amount to fraud.

Can Silence be Fraudulent?

The Explanation to Section 17 deals with cases as to when 'silence is fraudulent' or what is sometimes called 'constructive fraud.' The explanation declares that "mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, *unless*—

(*i*) the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak, or

(*ii*) silence is, in itself, equivalent to speech."

It therefore follows that —

1. *As a rule mere silence is not fraud* because there is no duty cast by law on a party to a contract to make a disclosure to the other party, of material facts within his knowledge.

ILLUSTRATION. *A* and *B*, being traders, enter upon a contract. *A* has private information of a change in prices which would affect *B*'s wilingness to proceed with the contract. *A* is not bound to inform *B* [Illustration *(d)* to Section 17].

2. *Silence is fraudulent, if the circumstances of the case are such that 'it is the duty of the person keeping silence to speak'.* In other words, silence is fraudulent in contracts of 'utmost good faith' *i.e.*, contracts '*uberrimae fidei.*' These are contracts in which the law imposes a duty of abundant disclosure on one of the parties thereto, due to peculiar relation-

[26]Cf. Desai, T.R., 'The Contract Act,' 13th Edn., p. 116.

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ship of the parties *or* due to the fact that one of the parties has peculiar means of knowledge which are not accessible to the other. The following contracts come within the class of 'uberrimae fidei' contracts:

(*a*) *Fiduciary relationship.* When the parties stand in a fiduciary relation to each other, the person in whom confidence is reposed is under a duty to act with utmost good faith and to make a full disclosure of all material facts concerning the transaction known to him. Examples of a fiduciary relationship include those of principal and agent, solicitor and client, guardian and ward, and trustee and beneficiary.

ILLUSTRATIONS. (*i*) Where a broker who was employed to buy shares for the client, sold his own shares to the client, without disclosing this fact to him and without obtaining his consent therefore, it was held that the sale can be avoided by the client (*Regier* vs *Campbell-Stuart*[27]).

(*ii*) Where solicitor purchased certain property from his client nominally for his brother, but really for himself, it was held that the sale can be avoided by the client, even if the transaction was perfectly proper one (*Macpherson* vs *Watt*[28]).

(*b*) *Contracts of insurance.* In contracts of marine, fire and life insurance, the insurer contracts on the basis that all material facts have been communicated to him; and it is an implied condition of the contract that full disclosure shall be made, and that if there has been non-disclosure he shall be entitled to avoid the contract. The assured, therefore must disclose to the insurer all material facts concerning the risk to be undertaken *e.g.*, disease *etc.*, in case of life insurance. A concealment or misstatement of a material fact will render the contract void (*Ratan Lal* vs *Metropolitan Co.*[29]).

(*c*) *Contract of marriage engagement.* Every material fact must be disclosed by both parties to a contract of marriage otherwise the other party is justified in breaking off the engagement (*Haji Ahmed* vs *Abdul Gani*[30]).

(*d*) *Contracts of family settlements.* Contracts of family settlements and arrangements also require full disclosure of all material facts within the knowledge of the parties to such contracts. Such a contract is not binding if either party has been misled by the concealment of material facts.

(*e*) *Share allotment contracts.* Promoters and directors, who issue the 'prospectus' of a company to invite the public to subscribe for shares and debentures, possess information which is not available to general public and as such they are required to disclose all information regarding the company with strict and scrupulous accuracy.

3. *Silence is fraudulent where the circumstances are such that "silence is, in itself, equivalent to speech."* Where, for example, *B* says to *A* — "If

[27](1939), Ch. 766.
[28]3 A.C. 254.
[29](1959), Pat. 413.
[30](1937), Nag.299.

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you do not deny it, I shall assume that the horse is sound." *A* says nothing. Hence *A's* silence is equivalent to speech. If the horse is unsound *A's* silence is fraudulent [Illustration (*c*) to Section 17].

Effect of Fraud

A party who has been induced to enter into a contract by fraud, has the following remedies open to him:

1. He can *rescind*[31] the contract *i.e.*, he can avoid the performance of the contract; contract being voidable at his option (Sec. 19); *or*

2. He can ask for *restitution* and insist that the contract shall be performed, and that he shall be put in the position in which he would have been, if the representation made had been true (Sec. 19).

ILLUSTRATION. *A*, fraudulently informs *B* that *A's* estate is free from encumbrance. *B* thereupon buys the estate. The estate is subject to a mortgage. *B* may either avoid the contract, or may insist on its being carried out and the mortgage debt redeemed. [Illustration (*c*) to Section 19].

3. The aggrieved party can also sue for *damages,* if any. Fraud is a 'civil wrong' hence compensation is payable. For instance, if the party suffers injury because of unsound horse, which was not disclosed despite enquiry, compensation can be demanded. Similarly, where a man was fraudulently induced to buy a house, he was allowed to recover the expense involved in moving into the house as damages (in addition to rescission of the contract) [*Doyle* vs *Olby* (*Ironmongers*) *Ltd.*[32]].

Special points. For giving rise to an action for deceit, the following points deserve special attention:

(*i*) Fraud by a stranger to the contract does not affect contract. It may be recalled that 'coercion' as well as 'undue influence' by a stranger to a contract affect the contract.

(*ii*) Fraudulent representation must have been instrumental in inducing the other party to enter into the contract *i.e.*, but for this, the aggrieved party would not have entered into the contract.

(*iii*) The plantiff must have been actually deceived by fraudulent statement. A deceit which does not deceive gives no ground for action.

(*iv*) The plaintiff must be thereby damnified. Unless the plaintiff has sustained a damage or injury, no action will lie. It is a common saying that "there is no fraud without damages."

(*v*) In cases of fraudulent silence, the contract is not voidable, if the party whose consent was so caused had the means of discovering the truth with ordinary diligence (Exception to Sec. 19 given in the Act). Note that

[31]The power to rescind is, however, lost in certain cases. For details refer to the heading — '*Loss of Right of Rescission*' later in this chapter.

[32](1969), 2 W.L.R. 673.

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in other cases of fraud, this is no defence *i.e.*, the contract is voidable even if the fraud could be discovered with ordinary diligence.

Distinction between Fraud and Misrepresentation

The following are the points of distinction between the two:

1. Fraud implies an intention to deceive, it is deliberate or wilful; whereas misrepresentation is innocent without any intention to deceive.

2. Fraud is a civil wrong which entitles a party to claim damages in addition to the right of rescinding the contract. Misrepresentation gives only the right to avoid the contract and there can be no suit for damages.

3. In case of misrepresentation, the fact that the aggrieved party had the means to discover the truth with ordinary diligence will prevent the party from avoiding the contract. But in case of fraud, excepting fraud by silence, the contract is voidable even though the party defrauded had the means of discovering the truth with ordinary diligence.

Loss of Right of Rescission[33]

We have observed earlier that a contract brought about by coercion, undue influence, misrepresentation or fraud is voidable at the option of the party whose consent was so caused. He has the option either to recind the contract or to affirm it. But his right of rescission is lost in the following cases:

1. **Affirmation.** If after becoming aware of his right to rescind, the aggrieved party affirms the transaction either by express words or by an act which shows an intention to affirm it, the right of rescission is lost. So, for example, if a person, who has purchased shares on the faith of a misleading prospectus, subsequently becomes aware of its falsity, but accepts dividends paid to him, he will not be permitted to avoid the contract. Paying for the goods purchased (if not paid so far), attempting to sell the goods are some other examples of implied affirmation.

2. **Restitution not possible.** If the party seeking rescission is not in a position to restore the benefits he may have obtained under the contract, *e.g.*, where the subject-matter of the contract has been consumed or destroyed, the right to rescind the contract cannot be exercised.

3. **Lapse of time.** It may be treated as evidence of affirmation where the party misled fails to exercise his rights promptly on discovering the representation to be untrue *or* on becoming aware of the fraud or coercion. As such the right of rescission may also be lost by too long-a-delay.

4. **Rights of third parties.** Since the contract is valid until rescinded, being a voidable contract, if before the contract is rescinded third parties, *bona fide* for value, acquire rights in the subject matter of the contract,

[33]This heading is *common to all* '*defects of consent*' discussed so far.

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those rights are valid against the party misled, and the right to rescind will no longer be available.[34] Thus where a person obtains goods by fraud and, before the seller rescinds the contract, disposes them off to a *bona fide* party, the seller cannot then rescind (*Phillips* vs *Brooks Ltd.*[35]).

MISTAKE

Mistake may be defined as an erroneous belief concerning something. It may be of two kinds:

1. Mistake of law.
2. Mistake of fact.

Mistake of Law

Mistake of law may be of two types:

(*a*) Mistake of law of the country;

(*b*) Mistake of foreign law.

(*a*) **Mistake of law of the country or Mistake of law.** Every one is deemed to be conversant with the law of his country, and hence the maxim "ignorance of law is no excuse." Mistake of law, therefore, is no excuse and it does not give right to the parties to avoid the contract. Stating the effect of mistake as to law, Section 21 declares that "a contract is not voidable because it was caused by a mistake as to any law in force in India." Accordingly, no relief can be granted on the ground of mistake of law of the country.

ILLUSTRATION (to Sec. 21). *A* and *B* make a contract grounded on the erroneous belief that a particular debt is barred by the Indian Law of Limitation; the contract is not voidable (*i.e.*, the contract is valid).

However, if one of the parties makes a 'mistake of law' through the inducement, whether innocent or otherwise, of the other party, the contract may be avoided.

(*b*) **Mistake of foreign law.** Mistake of foreign law stands on the same footing as the 'mistake of fact'. Here the agreement is void in case of 'bilateral mistake' only, as explained under the subsequent heading.

Mistake of Fact

Mistake of fact may be of two types:

1. Bilateral mistake; or
2. Unilateral mistake.

1. **Bilateral mistake.** Where the parties to an agreement misunderstood each other and are at cross purposes, there is a bilateral mistake. Here there

[34]Section 29 of the Sale of Goods Act.

[35](1919), 2 K.B. 243.

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is no real correspondence of offer and acceptance, each party obviously understanding the contract in a different way. In fact in such cases, there is no agreement at all, there being *entire absence* of consent. This has been termed by Salmond as '*error in consensus*' as distinguished from '*error in causa*' (*i.e.* where consent is not free and is caused by coercion, undue influence, misrepresentation or fraud). In case of bilateral mistake of essential fact, the agreement is void *ab-initio.* Section 20 provides that "where both the parties to an agreement are under a mistake as to a matter of fact essential to the agreement, the agreement is void" Thus for declaring an agreement void *ab-inito* under this Section, the following three conditions must be fulfilled:

(*i*) *Both the parties must be under a mistake i.e.*, the mistake must be mutual. Both the parties should misunderstand each other so as to nullify consent.

ILLUSTRATION. *M*, having two houses *A* and *B*, offers to sell house *A*, and *N* not knowing that *M* has two houses, thinks of house *B* and agrees to buy it. Here there is no real consent and the agreement is void.

(*ii*) *Mistake must relate to some fact and not to judgement or opinion etc.* An erroneous opinion as to the value of the thing which forms the subject-matter of the agreement is not to be deemed a mistake as to a matter of fact (Explanation to Section 20).

ILLUSTRATION. If *A* buys a motorcar, thinking that it is worth Rs 80,000, and pays Rs. 80,000 for it, when it is only worth Rs 40,000, the contract remains good. *A* has to blame himself for his ignorance of the true value of the motorcar and he cannot avoid the contract on the ground of mistake.

(*iii*) *The fact must be essential to the agreement i.e.,* the fact must be such which goes to the very root of the agreement. On the basis of judicial decisions, the mistakes which may be covered under this condition may broadly be put into the following heads:

(*a*) *Mistake as to the existence of the subject-matter of the agreement.* If at the time of the agreement and unknown to parties, the subject-matter of the agreement has ceased to exist, or if it has never been in existence, then the agreement is void (*Bell* vs *Lever Bros.*[36]).

ILLUSTRATIONS (to Sec. 20). (*a*) *A*, agrees to sell to B a specific cargo of goods supposed to be on its way from England to Bombay. It turns out that, before the day of the bargain, the ship conveying the cargo had been cast away, and the goods lost. Neither party was aware of these facts. The agreement is void.

(*b*) *A*, agrees to buy from *B* a certain horse. It turns out that the horse was dead at the time of the bargain, though neither party was aware of the fact. The agreement is void.

(*b*) *Mistake as to the identity of the subject-matter.* Where both parties

[36](1932), A.C. 161.

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are working under a mistake as to the identity of the subject-matter *i.e.*, one party had one thing in mind and the other party had another, the agreement is void for want of *consensus-ad-idem.*

ILLUSTRATION. Where there was a contract for the sale of a certain quantity of cotton arriving per '*ex ship Peerless,*' and there were two ships of that name sailing, and the parties had in mind different ships at the time of entering into the contract, *held* there was no contract. The Court observed: "the defendant meant one Peerless and the Plaintiff another. That being so, there was no *consensus-ad-idem* and therefore no binding contract." (*Reffles* vs *Wichelaus*)[37]

(c) *Mistake as to the title of the subject-matter.* Normally a mistake as to 'title of the seller' does not affect the validity of the contract because Section 14 of the Sale of Goods Act, 1930, imposes an implied 'condition' as to the title of the seller in a contract of sale, unless otherwise agreed. Accordingly, a seller is taken to warrant his title to the property sold and he may be made liable in damages for breach of the condition, even though both the parties contract under a mistaken belief as to the title of the seller. It is only in a very special circumstance, where a person agrees to purchase property or goods which unknown to himself and the seller, is his own already, that the agreement is void *ab-initio.*

ILLUSTRATION. *A* agreed to take a lease of fishery from *B*, though contrary to the belief of both parties at the time *A* was tenant for life by inheritance of the fishery and *B* had no title at all. It was held that the lease agreement was void (*Copper* vs *Phibbs*[38]).

(*d*) *Mistake as to the quantity of the subject-matter.* If both the parties are working under a mistake as to the quantity of the subject-matter, the agreement is void.

ILLUSTRATION. *P* enquired about the price of rifles from *H* stating that he may buy as many as 50. *H* quoted the price. *P* telegraphed "Send three rifles." The telegraph clerk transcribed the message as "Send the rifles." *H* sent 50 rifles. *P* accepted only three and returned 47. *H* filed a suit for damages for non-acceptance of 47 rifles. It was held that there was no contract as there was no consent and it made no difference even if the mistake was caused by the negligence of a third party. Of course *P* must pay the price of three rifles accepted by him (*Henkel* vs *Pope*[39]).

(*e*) *Mistake as to the quality of the subject-matter.* If there is a mutual mistake of both the parties as to the quality of the subject-matter *i.e.,* if the subject-matter is something *essentially different,* from what the parties believed it to be, the agreement is void.

ILLUSTARTIONS. (*a*) A set of table-linen was sold at an auction by a description 'with the crest of Charles I and the authentic property of that monarch.'

[37](1864), 2 H. & C. 906.
[38](1867), L.R. 2HL 149.
[39](1870), L.R. 6 Ex. 7.

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In fact the linen was Georgian and there was a mutual mistake of both parties as to the quality of subject-matter. Held, the agreement was void (*Nicholson & Venn.* vs *Smith Marriott*[40]).

(*b*) *A*, contracts to sell *B* a particular horse, which is believed by both the parties to be a race horse. But later on it turn out to be a cart horse. The agreement is void.

Strictly speaking it is the mistake as to 'substance' of the subject-matter going to the very root of the agreement and affecting the whole consideration which makes it void and not the mistake as to 'quality'. For, the principle of *caveat emptor* (let the buyer beware) clearly states that there is no implied warranty or condition as to the quality or fitness *for any particular purpose* of goods supplied under a contract of sale and the buyer must be held to have taken the risk that the goods sold might prove defective or might in some way be different from that which the parties believed it to be, in the absence of any misrepresentation or guarantee by the seller.

ILLUSTRATION. *A* sold certain seeds to *B*. Both parties honestly believed that the seeds were two years old. Actually the seeds proved to be only one year eleven months old. The contract cannot be avoided as the mistake does not affect the substance of the transaction.

(*f*) *Mistaken assumption going to the root of agreement.* Thus, where a man and woman entered into an agreement for separation on the erroneous assumption that their marriage was valid, the agreement was held void as the parties entered into the contract under a false and fundamental assumption that they were lawfully married. (*Galloway* vs *Galloway*[41]).

2. **Unilateral mistake.** Where only one of the contracting parties is mistaken as to a matter of fact, the mistake is a unilateral mistake. Regarding the effect of unilateral mistake on the validity of a contract, Section 22 provides that "a contract is not voidable merely because it was caused by one of the parties to it being under a mistake as to a matter of fact." Accordingly, in case of unilateral mistake a contract remains valid unless the mistake is caused by misrepresentation or fraud, in which case the contract is voidable at the option of aggrieved party. On the basis of judicial decisions, however, in certain exceptional cases even an unilateral mistake, whether caused by fraud, misrepresentation, *etc.*, or otherwise, may make an agreement void *ab-intio.*

With a view to elucidating the above mentioned various possibilities regarding the validity of a contract under unilateral mistake, we shall now discuss them in some detail.

Contract valid. If a man due to his own negligence or lack of reasonable care does not ascertain what he is contracting about, he must blame

[40](1947), 177 L.T. 189.
[41](1914), 30 T.L.R. 531.

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himself and cannot avoid the contract. Thus, as a rule, an unilateral mistake is not allowed as a defence in avoiding a contract *i.e.,* it has no effect on the contract and the contract remains valid.

ILLUSTARTIONS. (*a*) Where the government sold by auction the right of fishery and the plaintiff offered the highest bid thinking that the right was sold for three years, when in fact it was for one year only, he could not avoid the contract because it was his unilateral mistake caused by his own negligence. He ought to have ascertained the tenure of fishery before bidding at the auction (*A.A. Singh* vs *Unon of India*[42]).

(*b*) *X* buys rice from *Y*, by sample under the impression that the rice is old. The rice is, however, new. *X* cannot avoid the contract. The rule of *caveat emptor* (let the buyer beware) of the Sale of Goods Act is generally applicable in such cases of unilateral mistake as to quality of subject-matter of a contract, and despite the mistake the contract remains valid.

Contract voidable. If the unilateral mistake is caused by fraud or misrepresentation, *etc.*, on the part of the other party, the contract is voidable and can be avoided by the injured party.

ILLUSTRATION. *A,* has a horse with a hole in the hoof. *A*, so fills it up that the defect cannot be discovered on a reasonable examination. *B,* purchases the horse under the impression that the horse is sound. Here *A,* is guilty of fraud and as such on discovery of the defect *B* can avoid the contract because his unilateral mistake has been caused by *A*'s fraud.

Agreement void ab-initio. In the following two cases, where the consent is given by a party under a mistake which is so fundamental as goes to the root of the agreement and has the effect of nullifying consent, no contract will arise even though there is a unilateral mistake only:

1. *Mistake as to the identity of person contracted with, where such identity is important.* The rule of law is that a contract apparently made between *A* and *C* is a complete nullity, if the inference from the facts is that to the knowledge of *C*, it was the intention of *A* to contract only with *B,* for, there can be no real formation of an agreement by proposal and acceptance unless a proposal is accepted by the person to whom it is made. Thus, whenever the identity of the person with whom one intends to contract is important element of the contract, a mistake with regard to the person contracted with destroys his consent and consequently annuls the contract. It is important to note that in case of mistake as to identity of person contracted with, even if the mistake is committed because of fraud or misrepresentation of another party, the contract is not merely voidable but is absolutely void.

ILLUSTRATIONS. (*a*) *In Boulton* vs *Jones*:[43] Boulton had taken over the business of one Brocklehurst, with whom the defendant, Jones, had been accus-

[42](1970), A.I.R. Mani. 16.
[43](1857), 2 H. & N. 564.

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tomed to deal, and against whom he had a set-off. Jones sent an order for goods to Brocklehurst, which Boulton supplied without informing him that the business has changed hands. Jones consumed the goods in the belief that they had been supplied by Brocklehurst. When Boulton demanded the payment for the goods supplied, Jones refused to pay, alleging that he had intended to contract with Brocklehurst personally, since he had a set-off which he wished to enforce against him. Boulton, therefore, sued Jones for the price. It was held that Jones was not liable to pay for the goods. Pollock C.B. observed, "it is a rule of law that if a person intends to contract with *A, B* cannot give himself any right under it."

(*b*) In *Said* vs *Butt*:[44] Butt, the managing director of a theatrical company, gave instructions that no ticket was to be sold to Said, who was a very bad critic of all the plays of the company. Said, knowing this, asked a friend to buy a ticket for him. With this ticket Said went to the theatre but was refused admission. Said filed a suit for damages for breach of contract. *Held* that there was no contract because the theatrical company never intended to contract with Said. (Notice that in the given circumstances the identity of the plaintiff was a material element in the formation of the contract.)

(*c*) *In Cundy* vs *Lindsay*:[45] A fraudulent person named Blenkarn, taking advantage of the similarity of his name with that of a big company named Blenkiron & Co., in the same town, placed an order with Lindsey & Co., for supply of certain goods on credit and signed the order in such a way as to look like that of Blenkiron & Co. Lindsay & Co., mistook his order for that of Blenkiron & Co., and despatched the goods. Blenkarn took delivery of the goods and sold them to Cundy & Co., a *bona fide* purchaser for value, and did not pay Lindsay & Co., for them. On coming to know the true facts, Lindsay & Co., filed a suit on Cundy & Co., for recovery of goods. The Court of Appeal held that owing to mistake as to identity of contracting party caused by Blenkarn, the rogue, there was no consensus of mind which could lead to any agreement whatever between Blenkarn and Lindsay & Co., and hence the agreement was *void ab-initio* and Blenkarn got no title to the goods which he could pass to Cundy & Co. As Cundy & Co., obtained no title to the goods, it must return them or pay their price to Lindsay & Co.

Notice that in the above case if the contract between Blenkarn and Lindsay & Co., would have been merely voidable for fraud, Cundy & Co., would have been entitled to retain the goods as it had taken them in good faith for value, because in case of a voidable contract before it is repudiated, one can pass a good title to a *bonafide* purchaser for value. Hence the speciality of a mistake as to the identity of person contracted with becomes clear that in such a case, even if the mistake is committed because of misrepresentation or fraud of another party, the contract is absolutely void to the prejudice of third parties who later deal in good faith with the fraudulent person.

Further, "mistake as to the identity" of a party is to be distinguished

[44](1920), 3 K.B. 497.
[45](1878), 3 A.C. 459.

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from "mistake as to the attributes" of the other party. Mistake as to attributes, for example, as to the solvency or social status of that person, cannot negative the consent. It can only vitiate consent. It, therefore, makes the contract merely voidable for fraud. Thus where *X* enters into a contract with *Y*, falsely representing himself to be a richman, the contract is only voidable at the option of *Y*. Again where the identity of the party contracted with is immaterial, mistake as to identity will not avoid a contract. Thus if *X* enters a shop, introduces himself as *Y* and purchases some goods for cash, the contract is valid.

2. *Mistake as to the nature and character of a written document.* The second circumstance in which even an unilateral mistake may make a contract absolutely void is where the consent is given by a party under a mistake as to the nature and character of a written document. The rule of law is that where the mind of the signer did not accompany the signature; *i.e.*, he did not intend to sign; in contemplation of law, he never did sign the contract to which his name is appended and the agreement is void *ab-initio*.

ILLUSTRATIONS. (*a*) An old illiterate woman executed a deed under the impression that she was executing a power of attorney authorising her nephew to manage her estate, while in fact it was a deed of gift in favour of her nephew. The evidence showed that the woman never intended to execute such a deed of gift nor was the deed read or explained to her. The document was held to be void, as her mind did not go with her signature (*Bala Devi* vs *Santi Mazumdar*[46]).

(*b*) A blind man signed what he thought was a compromise petition, but was in fact a release, on the fraudulent representation of another, the document was held to be void (*Hem Singh* vs *Bhagwat*[47]).

(*c*) *M*, an old man with feeble sight, signed a bill of exchange for £ 3,000 thinking it was a guarantee. It was held that *M* was not liable (*Foster* vs *Mackinnon*[48]). In this case Byles J.,[49] made a very interesting observation: "It was as if he had written his name ... in a lady's album, or on an order for admission to the Temple Church, or in the fly-leaf of a book, and there had already been without his knowledge, a bill of exchange ... on the other side of the paper."

It should be borne in mind that in the aforesaid type of mistake, even if one party's consent is induced by misrepresentation of another, the contract is not merely voidable but is entirely void and the third party would acquire no rights (*Ningawwa* vs *Byrappa*[50]).

[46](1956), A.I.R. Cal. 575.
[47](1925), Pat. 140.
[48](1869), L.R. 4 C.P. 704. For an Indian case see: *Chimanram* vs *Divan Chand*, (1932), 56 Bom. 180.
[49]At p. 712.
[50](1968), A.I.R. S.C. 956.

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TEST QUESTIONS

1. "For giving rise to a valid contract, there must be *consensus ad-idem* among the contracting parties." Explain this statement and discuss the meaning of 'free consent.'

2. When is consent said to be given under coercion ? What is the liability of a person to whom money has been paid or goods have been delivered under coersion ? How coercion differs from undue influence ?

3. "It is an essential condition for challenging a contract on the basis of undue influence that one of the parties should be in a position to dominate the will of the other." Examine this statement and explain the effect of undue influence on the validity or otherwise of a contract.

4. Define the term 'misrepresentation.' What is its effect on the validity of a contract ? Distinguish it from fraud.

5. Define fraud and point out its effects on the validity of a contract. Give suitable examples to illustrate your answer.

6. "Mere silence as to facts is not fraud." Explain with illustrations.

7. What are contracts *Uberrimae Fidei ?* Give at least four examples of such contracts.

8. Distinguish clearly between (*a*) coercion and undue influence, and (*b*) misrepresentation and fraud.

9. Discuss the remedies available for coercion, undue influence, misrepresentation and fraud.

10. Discuss the law relating to the effect of 'mistake' on contracts.

11. "A contract caused by unilateral mistake may be valid, voidable or void." Explain.

12. Write notes on:
    (*a*) Unconscionable transactions.
    (*b*) Pardanashin women.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A*, sells a horse to *B* knowing fully well that the horse is vicious. *A* does not disclose the nature of the horse to *B*. Is the sale valid ?

[**Hint.** Yes, the sale is valid, because *A* is under no duty to disclose the fault to *B*, the general rule of law being "let the buyer beware."]

2. *A*, who is trying to sell an unsound horse, forges a veterinary surgeon's certificate, stating that the horse is sound and pins it on the stable door. *B* comes to examine the horse but the certificate goes unnoticed by him. He buys the horse and finds later on the horse to be unsound. He wants to avoid the agreement under the plea that he has been defrauded. Will he succeed?

[**Hint.** *B* will not succeed because he bought the horse after his examination and not on the basis of the Certificate. *B* has not therefore been deceived by the Certificate actually and a deceit which does not deceive is not fraud.]

3. *X* offers to sell *Y* a painting which *X* knows is a copy of a well known

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masterpiece. *Y*, thinking that the painting is an original one and that *X* must be unaware of this, immediately accepts *X's* offer. Does this result in a contract?

[Hint. Yes, there is a contract. The rule of *Caveat Emptor* applies in case of unilateral mistake as to quality of subject-matter of a contract, and despite the mistake the contract remains valid.]

4. *X* buys from *Y* a painting which both believe to be the work of an old master and for which *X* pays a high price. The painting turns out to be only a modern copy. Discuss the validity of the contract?

[Hint. The contract is absolutely void as there is a mutual mistake of both the parties as to the substance or quality of the subject-matter going to the very root of the contract. In case of bilateral mistake of essential fact, the agreement is void *ab-initio,* as per Section 20.]

5. *X,* falsely representing herself as the wife of a millionaire takes a ring from a jeweller's shop for the approval of her husband. She pledges it with a pawn broker who in good faith and without notice of the fraud pays her Rs. 1,000. Can the jeweller recover the ring from the pawn broker?

[Hint. The ring cannot be recovered from the pawn broker. The jeweller intended to contract with the person present before him. He was not mistaken about his identity but only about his attributes. His intention was to sell to the person present *i.e.*, there was consent, but it was vitiated by fraud. Hence the contract is voidable and not void. In case of a voidable contract, before it is repudiated, one can pass a good title to the pledgee or purchaser in good faith. Thus, in the instant case, the pledge is valid (*Phillips* vs *Brooks, 1919,* 2 K.B.243).

It may be noted that in the given case if *X* would have falsely represented herself as the wife of a *certain well known millionaire*, it would have been a case of mistake as to the identity of person contracted with, rendering the agreement void *ab-initio,* thereby enabling the jeweller to recover the ring from the pawn broker.]

6. *M,* an old man of poor sight endorsed a bill of exchange for Rs 3,000 thinking that it was a guarantee. Is *M* liable to pay the amount?

[Hint. *M* is not liable to pay the amount. The instant case belongs to the category of unilateral mistake as to the nature and character of a written document. In such cases the rule of law is that if the mind of the signer did not accompany the signature, in the eye of law, he never did sign and the agreement is void *ab-initio.*]

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Chapter 6

Legality of Object and Consideration

The object or consideration of an agreement must be lawful, in order to make the agreement a valid contract, for, Section 10 lays down that all agreements are contracts if made for lawful consideration and with a lawful object. Section 23 declares what kinds of considerations and objects are not lawful. If the object or consideration is unlawful for one or the other of the reasons mentioned in Section 23, the agreement is 'illegal' and therefore void (Sec. 23).

The use of the word 'illegal' is somewhat misnomering here. It usually connotes a punishable offence, but the parties to a so called "illegal agreement," unless it is expressly punishable by law or amounts to a criminal conspiracy, are not liable to punishment. They have committed no offence. They have merely concluded a transaction that will be spurned by the courts.[1]

The words 'object' and 'consideration' used in Section 23 are not synonymous. The word 'object' here means 'purpose or design.' Thus, where a person, while in insolvent circumstances, transferred his property to one of his creditors with the object of defrauding his other creditors, it was held that the agreement was void and the transfer was inoperative (*Jaffar Meher Ali* vs *Budge Budge Jute Mills Co.*[2]). The court observed that although the consideration of the contract was lawful but the object was unlawful because the purpose of the parties was to defeat the provisions of the Insolvency Law.

What Considerations and Objects are Unlawful?

According to Section 23, every agreement of which the object or consideration is unlawful is void, and the consideration or the object of an agreement is unlawful in the following cases:

1. **If it is forbidden by law.** This clause refers to agreements which are declared illegal by law. If the consideration or object for a promise is such

[1]Adapted from Chesire & Fifoot, *The Law of Contract*, IV Ed., p. 272.
[2](1906), 33 Cal. 702.

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as is forbidden by law, the agreement is void. An act or an undertaking is forbidden by law:

(a) when it is punishable by the criminal law of the country, or

(b) when it is prohibited by special legislation or regulations made by a competent authority under powers derived from the legislature.[3]

ILLUSTRATIONS. *(a)* Agreements for sale or purchase above the standard price fixed by the relevant law (*e.g.*, Essential Commodities Act, 1955) with regard to a controlled article are illegal and hence void (*Sita Ram* vs *Kunj Lal*[4]).

(b) An agreement to pay consideration to a tenant to induce him to vacate premises governed by the Rent Restriction Act is illegal and cannot be enforced because such an act is forbidden by the said Act *(Mohanchana* vs *Manindra*[5]).

2. If it is of such a nature that, if permitted, it would defeat the provisions of any law. This clause refers to cases where the object or consideration of an agreement is of such a nature that, though not directly forbidden by law, it would indirectly lend to a violation of law, whether enacted or otherwise (*e.g.*, Hindu and Mohammedan Laws). Such an agreement is also void.

ILLUSTRATIONS. *(a)* A loan granted under a promissory note to the guardian of a minor to enable him to celebrate the minor's marriage in contravention of the Child Marriage Restraint Act was held illegal and could not be recovered back (*Chandra Shrinivisa Rao* vs *Korrapati Raja Rama Mohana Rao*[6]).It will be seen that the purpose of borrowing in this case is of such a nature that if permitted it would defeat the provisions of Child Marriage Restraint Act of 1929,[7] for the money was lent to enable the guardian to celebrate the marriage contrary to the provisions of the said Act.

(b) An agreement by the debtor not to rise the plea of limitation, should a suit have to be filed, is void as tending to limit the provisions of the Limitation Act (*Rama Murthy* vs *Gopayya*[8]).

(c) An agreement between husband and wife to live separately is invalid as being opposed to Hindu Law (*A.E. Thimmal Naidu* vs *Rajammal*[9]).

3. **If it is fraudulent.** An agreement whose object or consideration is to defraud others, is unlawful and hence void.

ILLUSTRATIONS. *(a) A*, promises to pay Rs 200 to *B*, if *B* would commit fraud on *C*. *B* agrees. *B*'s agreeing to defraud is unlawful consideration for *A*'s promise to pay. Hence the agreement is illegal and void.

[3]Cf. Pollock and Mulla, *Indian Contract Act*, p. 138.
[4]A.I.R. (1963), All, 206.
[5]A.I.R. (1955), Cal. 442.
[6](1951), 2 Mad. L.J. 264.
[7]This Act has been repealed by the Child Marriage Restraint Act, 1978. The new Act raises the marriage age limit to 18 and 21 years for girls and boys respectively with effect from 2 October 1978.
[8](1917), 40 Mad.701.
[9](1968), A.I.R. Mad. 201.

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(b) A, B and *C* enter into an agreement for the division among them of gains acquired, or to be acquired, by them by fraud. The agreement is void, as its object is unlawful. [Illustration *(e)* to Section 23]

(c) A, being agent for a landed proprietor, agrees for money, without the knowledge of his principal, to obtain for *B* a lease of land belonging to his principal. The agreement between *A* and *B* is void as it implies a fraud by concealment by *A* on his principal. [Illustration *(g)* to Section 23]

4. **If it involves or implies injury to the person or property of another.** If the object or consideration of an agreement is injury to the person or property of another, it is void, being an unlawful agreement.

ILLUSTRATIONS. *(a)* An agreement to commit an assault or to beat a man has been held unlawful and void (*Allen* vs *Rescous*[10]).

(b) An agreement to put certain property to fire is unlawful and void under this clause.

(c) An agreement involving the publication of a libel (defamatory article against someone) has been held unlawful and void (*Clay* vs *Yates*[11]).

(d) An agreement by which a debtor, who borrowed Rs 100, promised to do manual labour without pay for the creditor, so long as the debt was not repaid in full has been held to be void, as it involved injury to the person of the debtor (*Ram Sarup* vs *Bansi Mandar*[12]).

5. If the court regards it as immoral. An agreement whose object or consideration is immoral, is illegal and therefore void. The scope of the word 'immoral' here extends to the following:

(i) Sexual immorality *e.g.,* illicit cohabitation or concubinage or prostitution.

ILLUSTRATIONS. *(a) A,* agrees to let her daughter to hire to *B* for concubinage. The agreement is void, because it is immoral, though the letting may not be punishable under the Indian Penal Code. [Illustration *(k)* to Section 23]

(b) A gift deed executed in consideration of illicit intercourse has been held void as its object was immoral (*Ghumma* vs *Ram Chandra*[13]).

It may be noted that an agreement to pay for 'past' or 'future' illicit cohabitation is also void, as being immoral. Consideration which is immoral at the time when it passes cannot become innocent by passage of time and therefore the consideration for past cohabitation is unlawful as being immoral (*Hussenali* vs *Dinbai*[14]). Similarly, a promise to pay for the purpose of future cohabitation, which comprised the consideration, was held illegal and void (*Lakshminarayana* vs *Subhadri*[15]).

(ii) Furtherance of sexual immorality.

[10]2 Lev. 174.
[11]1 H. & N. 73.
[12](1915), 42 Cal. 742.
[13](1926), 47 All. 619.
[14](1924), 25 Bom. L.R. 252.
[15](1903), 13 Mad. L.J. 7.

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ILLUSTRATIONS. *(a)* A prostitute was sued for the hire money of a carriage in which she used to go every evening in order to make a display of her beauty and thus to attract customers. The suit was dismissed on the ground that the plaintiff contributed towards the performance of an immoral and illegal act and hence he was liable to suffer (*Pearce* vs *Brooks*[16]).

(b) A man who knowingly lets out his house for prostitution cannot recover the rent, it being an act for furtherance of sexual immorality (*Choga Lal* vs *Piyasi*[17]). The landlord may, however, recover if he did not know the purpose.

(iii) Interference with marital relations.

ILLUSTRATIONS. (a) Money advanced to a married woman to enable her to procure a divorce and to marry the plaintiff could not be recovered back as the object of the agreement was held immoral (*Bai Vijli* vs *Nansa Nagar*[18]).

(b) An agreement for future separation between a husband and wife is void *ab-initio,* it being immoral in the eye of law.

(iv) Such acts which are against good public morals.

ILLUSTRATIONS. *(a)* An agreement for future marriage, after the death of first wife is against good morals and hence would be void (*Wilson* vs *Cornley*[19]).

(b) A, who is *B*'s mukhtar, promises to exercise his influence, as such with *B* in favour of *C* and *C* promises to pay Rs 1,000 to *A*. The agreement is void, because it is immoral. [Illustration *(j)* to Section 23]

6. **If the court regards it as 'opposed to public policy.'** An agreement is unlawful if the court regards it as 'opposed to public policy.' It is not possible to give a precise or exact definition of the term 'public policy.' It is rather an elastic term and its connotation may vary with the social structure of a State. Public policy is that principle of law which holds that no citizen can lawfully do that which is injurious to the public or is against the interests of the society or the State. Broadly speaking, an agreement which tends to promote corruption or injustice or immorality is said to be opposed to public policy. It is interesting to note that 'opposed to public policy' and 'immoral,' both are very much similar in nature because what is 'immoral' must be 'opposed to public policy' and reverse is also true in most cases.

Public policy is an illusive concept. It has been described as an 'untrustworthy guide,' 'unruly horse,' *etc.,* and therefore, the doctrine of public policy is generally governed by precedents. In *Gherulal* vs *Mahadeodas*[20] the Supreme Court observed, "... though the heads (of public policy) are not closed and though theoretically it may be permissible to evolve a new head under exceptional circumstances of a changing world, it is advisable in the

[16](1866), L.R.1 Ex. 213.
[17](1909), 31 All. 58.
[18](1885), 10 Bom. 152.
[19](1908), 1 K.B. 729.
[20](1959), A.I.R. S.C. 781.

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interest of stability of society not to make any attempt to discover new heads in these days." The courts, thus, are generally disinclined to invent new heads of public policy.

On the basis of decided cases on the subject the following agreements have been held to be against public policy:

(i) Trading with an alien enemy. It is now fully established that trading with an alien enemy (*i.e.,* a citizen of the other country at war with the State) is against public policy in so far as it tends to aid the economy of the enemy country. Such agreements are therefore illegal, unless made with the special permission of Government. It is to be noted that an agreement to promote hostile action in a friendly State is also illegal and void as being opposed to public policy.

(ii) Agreements interfering with the course of justice. An agreement the object of which is to interfere with the course of justice, *e.g.,* an agreement not to disclose misconduct to the other interested party or an agreement to influence a judge to induce him to decide the case in a party's favour, is obviously opposed to public policy and is void. But an agreement to refer present or future disputes to arbitration is a valid agreement.

(iii) Agreements for stifling criminal prosecution. It is well settled law that if a person has committed a crime, he must be punished. Hence any agreement which seeks to prevent the prosecution of a guilty party is opposed to public policy and is void, for "no one can be allowed to make a trade of a felony." In *Sudhindra Kumar* vs *Ganesh Chandra,*[21] Mukherjee, J., has observed: "No court of law can countenance or give effect to an agreement which attempts to take the administration of law out of the hands of the judges and put it in the hands of private individuals." Where, therefore, *A* promises *B* to drop a prosecution which he has instituted against *B* for robbery, and *B* promises to restore the value of the thing taken, the agreement is void, as its object is unlawful.[22] Similarly, the compromise of a public offence is illegal. It is obvious that if such a course is allowed to be adopted and agreements made between the parties based solely on the consideration of stifling criminal prosecutions are sustained, the basic purpose of Criminal Law would be defeated. However, under the Indian Criminal Procedure Code there are certain compoundable offences (*e.g.,* assault) which can be compromised and agreements for the compromise of such offences are valid (*Ramachandra* vs *Bhauwari Bai*[23]).

(iv) Maintenance and Champerty. 'Maintenance' may be defined as an agreement whereby a stranger promises to help another person by money

[21](1939), I Cal. 241.
[22]Illustration (h) to Section 23.
[23](1973), A.I.R. Raj. 260.

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or otherwise in litigation in which that third person has himself no legal interest. 'Champerty' is an agreement whereby a person agrees to assist another in litigation in exchange of a promise to hand over a portion of the proceeds of the action. Thus, in both cases financial or professional assistance is provided with a view to assisting another person in litigation but in case of Champerty the party helping in litigation also shares in the gains of the litigation in addition to interest on money advanced or fees for professional services.

Under the English Law such agreements are absolutely void. The Indian Law, however, does not make them absolutely void because of the peculiar position of Indian litigants many of whom are too poor to afford expensive litigation. "The uncertainties of litigation are proverbial; and if the financier must need risk losing his money he may well be allowed some chances of exceptional advantage" (*Ram Sarup* vs *Court of Wards*[24]).

The rules applied in India are as follows:

1. An agreement *for supplying funds* by way of 'maintenance' or 'Champerty' is valid, unless:

(a) it is unreasonable so as to be unjust to the other party, or

(b) it is made by a malicious motive like that of gambling in litigation or oppressing other party by encouraging unrighteous suits, and not with the *bona fide* object of assisting a claim believed to be just (*Bhagwat Dayal Singh* vs *Debi Dayal Sahu*).[25]

2. An agreement *for providing professional services* is valid if it is made by way of 'maintenance' and with a *bona fide* object of assisting a claim believed to be just and obtaining a reasonable recompense therefor. But if it is made by way of 'Champerty', *i.e.,* making the remuneration dependent to any extent whatsoever upon the result of the suit, it is void (*Kothi Jairam* vs *Vishvanath*[26]).

ILLUSTRATIONS. *(a)* Where 75 paise in a rupee was agreed as the share of the financier, out of the property recovered, it was held that the agreement was unreasonable and hence void. However, the plaintiff (financier) was awarded the expenses legitimately incurred by him with interest (*Nuthaki Venkataswami* vs *Katta Nagi Reddy*[27]).

(b) An agreement by a client to pay his lawyer according to the result of the case was held opposed to public policy and void, it being against the professional code of conduct (*Kothi Jairam* vs *Vishvanath*[28]).

(v) Traffic in public offices. Agreements for sale or transfer of public

[24](1940), 67 I.A. 50.
[25](1908), 35 Cal. 420.
[26](1925), A.I.R. Bom. 470.
[27]A.I.R. (1962) A.P. 457.
[28]A.I.R. (1925) Bom. 470.

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offices or for appointments to public offices in consideration of money are illegal, being opposed to public policy. Such agreements, if enforced, would lead to inefficiency and corruption in public life.

ILLUSTRATIONS. *(a) A,* promises to obtain for *B* an employment in the public service, and *B* promises to pay Rs 1,000 to *A*. The agreement is void as the consideration for it is unlawful [Illustration *(f)* to Section 23].

(b) So also a promise to pay money to a public servant to induce him to retire and make way for the appointment of the promisor is void (*Saminatha* vs *Muthusami*[29]).

(vi) Agreements creating an interest opposed to duty. An agreement which tends to create a conflict between interest and duty is illegal and void on the ground that it is opposed to public policy.

ILLUSTRATIONS. *(a) A*, agrees to pay *B*, the lieutenant colonel in the army, Rs 50,000 if he will assist her brother to desert the army. The object of the agreement is opposed to public policy and hence the agreement is void and illegal.

(b) An agreement by an agent with a third party whereby he would be enabled to make secret profits is illegal and void as it tends to create a conflict between interest and duty.

(vii) Agreements unduly restraining personal liberty. Agreements which unduly restrict personal freedom have been held to be void and illegal as being against public policy.

ILLUSTRATION. *A,* borrowed money from *B,* a moneylender, and agreed that he would not, without the written consent of *B,* leave his job, borrow money, dispose of his property or change his residence. It was held that the agreement was illegal as it unduly restricted the liberty of *A* (*Harwood* vs *Miller's Timber and Trading Co.*[30]).

(viii) Agreements interfering with parental duties. A father, and in his absence the mother, is the legal guardian of his/her minor child. The authority of a guardian is to be exercised in the best interest of the child, in accordance with good public morals. If, therefore, the right of guardianship is bartered away by any agreement which is inconsistent with the duties arising out of such custody, such an agreement shall be void on the ground of public policy.

ILLUSTRATION. For monetary consideration, *A* agrees to place his daughter at the disposal of *B* to be married as *B* likes. The agreement is illegal and void as it would interfere with *A*'s parental duty to select a husband in the best interests of the girl (*Atma Ram* vs *Banku Mal*[31]).

(ix) Marriage brokerage agreements. These are agreements for the payment of money in consideration of procuring for another in marriage a husband or a wife. Such agreements are illegal and void as being contrary

[29](1907), 30 Mad. 530.
[30](1917), 1 K.B. 305.
[31](1930), Lah. 561.

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to public policy. Thus, when a 'Prohit' was promised Rs 200 in consideration of procuring a wife for the defendant, the agreement was held invalid and the money could not be recovered (*Pitamber* vs *Jagjiwan*[32]).

Further, an agreement of dowry[33] *i.e.,* to give money or property to the parents of the bride or the bridegroom in connection of their agreeing to the contract of marriage is also illegal and cannot be enforced. But such an agreement is illegal in respect of payment only, the validity of marriage is not affected. So, once the marriage is solemnised, money if actually paid cannot be recovered back, and if not paid, a suit therefore would not lie, because the agreement to pay is illegal. Of course the money can be recovered when the marriage is not performed (*Dharnidhar* vs *Kanhji Sahay*[34]). Similarly, clothes and ornaments or their value can be recovered if the marriage does not take place (*Girdhari Singh* vs *Neeladhar Singh*[35]).

(x) Miscellaneous cases. The following agreements have also been held to be against public policy:

(a) Agreements "tending to create monopolies" are illegal and void (*Kameshwar Singh* vs *Yasin Khan* [36]).

(b) Agreements to defraud revenue authorities are void and illegal. For example, an agreement by which an employee was to get, in addition to salary, an expense allowance grossly in excess of the expenses actually incurred by him, was held illegal because the provision as to expenses was contrary to public policy being merely a device to defraud the income-tax authorities (*Napeier* vs *National Business Agency Ltd.*[37]).

(c) Agreements whereby money is given to induce persons to give evidences in a civil court are void because every one is expected to perform his legal duty (*Adhiraja Shatty* vs *Vittil Bhatta*[38]).

Object or Consideration Unlawful in Part

Section 23 (already discussed) deals with cases in which object or/and

[32]13 Bom. 131.

[33]The Dowry Prohibition Act, 1961 had defined dowry as property given directly or indirectly by one party to another, by parents of one party to either party at or before or after the marriage in consideration of marriage. The Dowry Prohibition (Amendment) Act, 1984 has changed the definition of dowry slightly. The new Act has defined dowry as property given in connection (not consideration) with marriage. The Amendment Act, however, clarifies that presents given to the bride or the bridegroom at the time of marriages, voluntarily, without a demand being made, will not be treated as dowry. But these presents will have to be carefully listed in accordance with the rules of the Amendment Act.

[34]A.I.R. (1949), Pat. 250.

[35](1912), 16 I.C. 1004.

[36](1938), Pat. 473.

[37](1951), 2 All. E.R. 264.

[38]A.I.R. (1914), Mad. 366.

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consideration is wholly illegal. But what is the position if the same agreement contains both legal and illegal terms, *i.e.*, it is partly legal and partly illegal? Sections 24, 57 and 58 of the Contract Act provide for such cases. Accordingly, if the object or consideration is partially unlawful, the following rules will apply:

1. When an agreement contains several distinct promises to do things legal and also other things illegal, and the legal part cannot be separated from the illegal part (*i.e.*, the consideration for different promises is a single sum of money), the whole agreement is illegal and void (Sec.24).

ILLUSTRATIONS. *(a) A,* promises to superintend, on behalf of *B,* a legal manufacture of indigo and an illegal traffic in other articles. *B* promises to pay to *A* a salary of Rs. 10,000 a year. The agreement is void and unlawful. Here a part of the object is legal and a part is illegal which are not severable because the consideration for both promises is a single sum of money (Illustration to Section 24).

(b) A, agrees to serve *B* as his housekeeper and also to live in adultery with him at a fixed salary. The whole agreement is unlawful and void. *A* cannot sue even for service rendered as housekeeper because it cannot be ascertained as to what was due on account of adulterous intercourse and what was due for housekeeping (*Alice Hill* vs *William Clarke*[39]).

2. Where there is reciprocal promise to do things legal and also other things illegal, and the legal part can be separated from the illegal part (*i.e.*, there is a separate consideration for different promises), the legal part is a contract and the illegal part is a void agreement (Sec. 57).

ILLUSTRATION. *A* and *B* agree that *A* shall sell *B* a house for Rs 10,000, but that, if *B* uses it is as a gambling house, he shall pay *A* Rs 50,000 for it. The first set of reciprocal promises, namely, to sell the house and to pay Rs 10,000 for it, is a contract. The second set is for an unlawful object, namely, that *B* may use the house as a gambling house, and is a void and illegal agreement. (Illustration to Section 57). Here it is to be noted that the two promises are distinct and severable with a separate consideration for each such promise. The promises are thus independent of each other except that they form part of the same contract.

3. In the case of an alternative promise, one branch of which is legal and the other illegal, the legal branch alone can be enforced (Sec. 58).

ILLUSTRATION. *A* and *B* agree that *A* shall pay *B* Rs 1,000 for which *B* shall afterwards deliver to *A* either rice or smuggled opium. This is a valid contract to deliver rice and a void and unlawful agreement as to opium (Illustration to Section 58).

Effect of Illegal Agreements on Collateral Transactions

While discussing different kinds of contracts in Chapter 1 we have already seen that an 'illegal agreement' like the 'void agreement' is unen-

[39](1905), 27 All. 266.

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forceable as between the immediate parties. But an 'illegal agreement' has this further effect that other transactions which are incidental or collateral to it are also tainted with illegality and, therefore, are not enforceable, provided the parties to the collateral transaction had the knowledge of the illegal or immoral design of the main or primary agreement (a void agreement does not invalidate collateral transaction[40]).

ILLUSTRATIONS. *(a) A* enters into a smuggling of goods agreement with *B* and borrows Rs 1,000 from *C* for giving an advance to *B*. C cannot recover the money lent if he knew the illegal purpose, because his loan agreement was a collateral transaction to an illegal agreement. Of course if *C* did not know the purpose of the loan, he can recover even though *A* had used the money for an illegal object.

(b) A bets on a horse race with *B* and borrows Rs 500 from *C* for this purpose. *C* can always recover the money lent, whether he knew the purpose of loan or not, because his loan agreement was collateral to a void (wagering) agreement only.

No restitution is allowed. Parties to an illegal agreement cannot get any help from a court of law, for, "no polluted hand shall touch the pure fountain of justice." So, nothing can be recovered under an illegal agreement and if something has been paid it cannot be recovered back, whether the illegal object has been carried out or has not been carried out, is immaterial. The rule of law is that "no action is allowed on an illegal agreement" and "in case of equal guilt, the position of the defendant is better than that of the plaintiff."

ILLUSTRATION. *X* promises *Y* to pay Rs 10,000 if he murders *Z*. If *Y* commits the murder, he cannot recover the amount from *X*. If *X* has already paid the amount and *Y* fails in murdering *Z*, *X* cannot recover the amount back.

TEST QUESTIONS

1. In what cases the object and consideration of an agreement are said to be unlawful under the Contract Act? Illustrate with examples.
2. What do you understand by an illegal agreement? What is the effect of illegal agreements on collateral transactions?
3. "An agreement is illegal and shall not be enforced if the court regards it as immoral." Comment.
4. Discuss the doctrine of public policy. Name the various types of agreements which are considered to be opposed to public policy. Are the categories of public policy closed?
5. Examine the validity of agreements with consideration and object unlawful in part.

[40] 'Illegal' and 'Void' agreements have been distinguished in detail in Chapter 1 under the heading "*Illegal and Void Agreements Distinguished.*"

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PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* promises to pay a certain sum of money to *B*, who is an intended witness in a suit against *A*, in consideration of *B*'s absenting himself at the trial. *B* absents but fails to get the money. Can he recover?

[Hint. *B* cannot recover the money because an agreement which tends to create a conflict between interest and duty is illegal and void being opposed to public policy.]

2. In a suit by *A* against *B* for the recovery of Rs 5,000, *A* is in need of money. *C* agrees to provide funds to *A* in consideration of sharing one-fourth of the money recovered from *B*. Decide the validity of the agreement between *C* and *A*.

[Hint. The agreement between *C* and *A* is valid. It is a champertous agreement which is valid provided its terms are fair and reasonable and is made with a *bona fide* object of assisting a just claim.]

3. *A*, while his wife *B* was alive, promised to marry *C* in the event of *B's* death. Subsequently *B* died but *A* refused to marry. *C* sues *A* for damages for breach of promise. Decide.

[Hint. *C* will not succeed because an agreement for future marriage, after the death of first wife is against good public morals and hence illegal and void (*Wilson* vs *Carnley,* 1908, 1 K.B.729)].

4. *A*, entered into an agreement with *B* and engaged *B* for the purpose of performing *puja* (prayer) for *A*'s success in a suit which he had before the court and promised to pay Rs 2,000 in the event of success. *A* succeeded in the suit. *B* used *A* for the amount agreed upon. Will *B* succeed?

[Hint. No, *B* will not succeed as the object of the agreement is to interfere with the course of justice, making the agreement illegal and void. It has been held that where the object of an agreement is to exercise some extraneous influence, unauthorised by law, on the mind of the court, the agreement is contrary to public policy and hence void [*Bhagwan Datt Shastri* vs *Raja Ram,* (1927) All. 406]. However, in *Balasundara Mudaliar* vs *Mahomed Usman,* A.I.R. (1929) Mad. 812, a promise of reward by a Muslim litigant to a Hindu devotee in consideration of offering prayers for the success of his suit has been held not against public policy. Thus accordingly the agreement between *A* and *B* is valid and *B* must succeed.]

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Chapter 7

Void Agreements

"An agreement not enforceable by law is said to be void" [Sec.2(g)]. Thus a void agreement does not give rise to any legal consequences and is void *ab-initio*. In the eye of law such an agreement is no agreement at all from its very inception.

We have already dealt with the following types of void agreements in the preceding chapters, and will not therefore discuss them here again:

1. Agreements by a minor or a person of unsound mind (Sec.11) (Refer to Chapter 4).
2. Agreements made under a bilateral mistake of fact material to the agreement (Sec. 20) (Refer to Chapter 5).
3. Agreements of which the consideration or object is unlawful (Sec. 23) (Refer to Chapter 6).
4. Agreements of which the consideration or object is unlawful in part and the illegal part cannot be separated from the legal part (Sec. 24) (Refer to Chapter 6).
5. Agreements made without consideration (Sec. 25) (Refer to Chapter 3).

EXPRESSLY DECLARED VOID AGREEMENTS

The last essential of a valid contract as declared by Section 10 is that it must not be one which is 'expressly declared' to be void by the Act. Thus, there arises a question, as to what are 'expressly declared' void agreements? The following agreements have been 'expressly declared', to be void by the Indian Contract Act:

1. Agreements in restraint of marriage (Sec. 26).
2. Agreements in restraint of trade (Sec. 27).
3. Agreements in restraint of legal proceedings (Sec. 28).
4. Agreements the meaning of which is uncertain (Sec.29).
5. Agreements by way of wager (Sec. 30).
6. Agreements contingent on impossible events (Sec.36).
7. Agreements to do impossible acts (Sec. 56).

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At the very outset, it may be borne in mind that the law declares these agreements void *ab-initio* and not illegal, and therefore transactions collateral to such agreements are not made void. In fact it is for this reason that these agreements have not been discussed in the preceding chapter dealing with "unlawful or illegal agreements," because otherwise, in effect, these agreements are also 'unlawful agreements' as they are expressly declared void by the Contract Act. It may be recalled that in the case of illegal agreements, transactions collateral to them are also tainted with illegality and hence void.

1. **Agreements in Restraint of Marriage**

Every individual enjoys the freedom to marry and so according to Section 26 of the Contract Act "every agreement in restraint of the marriage of any person, other than a minor, is void." The restraint may be general or partial but the agreement is void, and therefore, an agreement agreeing not to marry at all, or a certain person, or a class of persons, or for a fixed period, is void. However, an agreement restraining the marriage of a minor is valid under the Section.

It is interesting to note that a promise to marry a particular person does not imply any restraint of marriage, and is, therefore, a valid contract.

ILLUSTRATIONS. (*a*) *A* agrees with *B* for good consideration that she will not marry *C*. It is a void agreement.

(b) A agrees with *B* that she will marry him only. It is a valid contract of marriage.

2. **Agreements in Restraint of Trade**

The Constitution of India guarantees the freedom of trade and commerce to every citizen and therefore Section 27 declares "every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void." Thus no person is at liberty to deprive himself of the fruit of his labour, skill or talent, by any contracts that he enters into.

It is to be noted that whether restraint is reasonable or not, if it is in the nature of restraint of trade, the agreement is void always, subject to certain exceptions provided for statutorily.

ILLUSTRATION. An agreement whereby one of the parties agrees to close his business in consideration of the promise by the other party to pay a certain sum of money, is void, being an agreement is restraint of trade, and the amount is not recoverable, if the other party fails to pay the promised sum of money (*Madhub Chander* vs *Raj Kumar*[1]).

But agreements merely restraining freedom of action necessary for the carrying on of business are not void, for the law does not intend to take

[1](1874), 14 B.L.R. 76.

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away the right of a trader to regulate his business according to his own discretion and choice.

ILLUSTRATION. An agreement to sell all produce to a certain party, with a stipulation that the purchaser was bound to accept the whole quantity, was held valid because it aimed to promote business and did not restrain it (*Mackenzie* vs *Striramiah*[2]). But where in a similar agreement the purchaser was free to reject the goods (*i.e.*, was not bound to accept the whole quantity tendered) it was held that the agreement was void as being in restraint of trade (*Sheikh Kalu* vs *Ram Saran*[3]).

Exceptions. An agreement in restraint of trade is valid in the following cases:

1. **Sale of goodwill.** The seller of the 'goodwill' of a business can be restrained from carrying on a similar business, within specified local limits, so long as the buyer, or any person deriving title to the goodwill from him, carries on a like business therein, provided the restraint is reasonable in point of time and space (Exception to Sec. 27).

ILLUSTRATIONS. (*a*) *A*, after selling the goodwill of his business to *B* promises not to carry on similar business "anywhere in the world." As the restraint is unreasonable the agreement is void.

(b) C, a seller of imitation jewellery in London sells his business to *D* and promises that for a period of two years he would not deal: (a) in imitation jewellery in England, (b) in real jewellery in England, and (c) in real or imitation jewellery in certain foreign countries. The first promise alone was held lawful. The other two promises, namely (b) and (c), were held void as the restraint was unreasonable in point of space and the nature of business (*Goldsoll* vs *Goldman*[4]).

2. **Partners' agreements.** An agreement in restraint of trade among the partners or between any partner and the buyer of firm's goodwill is valid if the restraint comes within any of the following cases:

(a) An agreement among the partners that a partner shall not carry on any business other than that of the firm while he is a partner [Section 11(2) of *the Partnership Act].*

(b) An agreement by a partner with his other partners that on retiring from the partnership he will not carry on any business similar to that of the firm within a specified period or within specified local limits, provided the restrictions imposed are reasonable [Section 36(2) of *the Partnership Act].*

(c) An agreement among the partners, upon or in anticipation of the dissolution of the firm, that some or all of them will not carry on a business similar to that of the firm within a specified period or within specified local limits, provided the restrictions imposed are reasonable (Section 54 of *the Partnership Act*).

(d) An agreement between any partner and the buyer of the firm's

[2](1890), 13 Mad. 472.
[3](1909), 13 Cal. W.N.388.
[4](1915), 1 Ch. 292.

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goodwill that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits, provided the restrictions imposed are reasonable [Section 55(3) of *the Partnership Act*].

3. **Trade combinations.** As pointed out earlier, an agreement, the primary object of which is to regulate business and not to restrain it, is valid. Thus, an agreement in the nature of a business combination between traders or manufacturers *e.g.*, not to sell their goods below a certain price, to pool profits or output and to divide the same in an agreed proportion, does not amount to a restraint of trade and is perfectly valid (*Fraser & Co.* vs *Bombay Ice Company*[5]). Similarly, an agreement amongst the traders of a particular locality with the object of keeping the trade in their own hands is not void merely because it hurts a rival in trade (*Bhola Nath* vs *Lachmi Narain*[6]). But if an agreement attempts to create a monopoly, it would be void (*Kameshwar Singh* vs *Yasin Khan*[7]). Agreements tending to create monopolies are now also governed by the provisions of the Monopolies and Restrictive Trade Practices Act, 1969, which forbids certain types of trade agreements.

4. **Negative stipulations in service agreements.** An agreement of service by which a person binds himself *during the term of the agreement,* not to take service with anyone else, is not in restraint of lawful profession and is valid. Thus a chartered accountant employed in a company may be debarred from private practice or from serving elsewhere during the continuance of service (*Maganlal* vs *Ambica Mills Ltd.*[8]) But an agreement of service which seeks to restrict the freedom of occupation for some period, *after the termination of service,* is void. Thus, where *S*, who was an employee of Brahmputra Tea Co. Assam, agreed not to employ himself or to engage himself in any similar business within 40 miles from Assam, for a period of five years from the date of the termination of his service, it was held that the agreement is in restraint of lawful profession and hence void (*Brahamputra Tea Co.* vs *Scarth*[9]).

3. Agreements in Restraint of Legal Proceedings

Section 28 declares the following two kinds of agreements void:

1. An agreement by which a party is restricted *absolutely* from taking usual legal proceedings, in respect of any rights arising from a contract.

2. An agreement which limits the time within which one may enforce

[5](1905), 29 Bom. 107.
[6](1931), 53 All. 316.
[7](1938), Pat. 473.
[8]A.I.R. (1964) Guj. 216.
[9](1885), 11 Cal. 545.

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his contract rights, without regard to the time allowed by the Limitation Act.

Restriction on Legal proceedings. As stated above Section 28 renders every agreement in restraint of legal proceedings void. This is in furtherance of what we studied under the definition of a 'contract', namely, agreement *plus* enforceability at law is a contract. Thus if an agreement *inter-alia* provides that no party shall go to a court of law, in case of breach, there is no contract and the agreement is void *ab-initio.* In this connection the following points must also be borne in mind:

(*a*) The Section applies only to rights arising from a contract. It does not apply to cases[10] of civil or criminal wrongs or torts.

(*b*) This Section does not affect the law relating to arbitration *e.g.*, if the parties agree to refer to arbitration any dispute which may arise between them under the contract, such a contract is valid (*Exceptions* 1 and 2 to Section 28).

(*c*) The Section does not affect an agreement whereby parties agree "not to file an appeal" in a higher court. Thus where it was agreed that neither party shall appeal against the trial court's decision, the agreement was held valid, for, Section 28 applies only to *absolute* restriction on taking the legal proceedings, whereas here the restriction is only *partial* as the parties can go to a court of law alright and the only restriction is that the losing party cannot file an appeal (*Kedar Nath* vs *Sita Ram*[11]).

(*d*) Lastly, this Section does not prevent the parties to a contract from selecting one of the two courts which are equally competent to try the suit. Thus in *A. Milton & Co.* vs *Ojha Automobile Engineering Company's Case*[12], there was an agreement which *inter-alia* provided — "Any litigation arising out of this agreement shall be settled in the High Court of Judicature at Calcutta, and in no other court whatsoever." The defendants filed a suit in Agra whereas the plaintiff brought a suit in Calcutta. It was held that the agreement was binding between the parties and it was not open to the defendants to proceed with their suit in Agra.

Curtailing the period of limitation. Any agreement curtailing the period of limitation prescribed by the Limitation Act is also void under Section 28. Thus, if a clause in an agreement between *A* and *B* provides that either party can sue for breach within a year of breach only, the clause is void and despite the clause the parties have a right to sue in case of breach by either party within the time allowed by the Limitation Act *i.e.*, within

[10]Such cases come under "*Agreements Stifling Prosecutions*" which have been discussed in the preceding chapter.

[11]A.I.R. (1969) Bom. 221.

[12]A.I.R. (1931) Cal. 279. Also see *Hakam Singh* vs *Gamman (India) Ltd.*, (1971) 1 S.C.C. 286.

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three years from the date of breach. It is relevant to state that agreements extending the period of limitation prescribed by the Limitation Act are also void, not under this Section but under Section 23, as the object will be to defeat the provisions of the law (*Rama Murthy* vs *Gopayya*[13]).

Effect of release or forfeiture agreements. Agreements which do not limit the time within which contract rights may be enforced, but only provide for release or forfeiture of such rights if suit is not brought within an agreed time (say 3 months), are outside the scope of Section 28, and they are binding between the parties.

ILLUSTRATION. In a contract of fire insurance, it was provided that if a claim is rejected and a suit is not filed within three months after such rejection, all benefits under the policy shall be forfeited. The provision was held valid and binding and the suit filed after three months was dismissed (*Baroda Spinning Co. Ltd.* vs *Satyanarayan Marine & Fire Insurance Co. Ltd.*[14]).

Notice that the above agreement does not curtail the period within which a suit may be brought to enforce rights, but only provides that there shall no longer be any rights to enforce. Such a stipulation is not illegal in itself, because it does not affect the remedy but it extinguishes the right itself. The observation made by Batchelor J. in the *Baroda Spinning Company's case,* supra, makes the distinction absolutely clear: "In my opinion, however, the distinction, which beyond question exists, is vital in the construction of the Section. As I understand the matter, what the plaintiff was forbidden to do was to limit the time within which he was to enforce his rights; what he has done is to limit the time within which he is to have any rights to enforce; and that appears to me to be a very different thing."

4. Uncertain Agreements

"Agreements, the meaning of which is not certain, or capable of being made certain, are void" (Sec. 29). Through Section 29 the law aims to ensure that the parties to a contract should be aware of the precise nature and scope of their mutual rights and obligations under the contract. Thus, if the words used by the parties are vague or indefinite, the law cannot enforce the agreement.

ILLUSTRATIONS (to Sec. 29). (*a*) *A* agrees to sell to *B* "a hundred tons of oil." There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty.

(*b*) *A,* who is a dealer in coconut oil only, agrees to sell to *B* "one hundred tons of oil." The nature of *A's* trade affords an indication of the meaning of the words, and *A* has entered into a contract for the sale of one hundred tons of coconut oil.

[13](1917), 40 Mad. 701.
[14](1914), 38 Bom. 344.

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(*c*) *A* agrees to sell to *B* "one thousand maunds of rice at a price to be fixed by *C*." As the price is capable of being made certain, there is no uncertainty here to make the agreement void.

(*d*) *A* agrees to sell to *B* "his white horse for rupees five hundred or rupees one thousand." There is nothing to show which of the two prices was to be given. The agreement is void.

Further, an agreement "to enter into an agreement in future" is void for uncertainty unless all the terms of the proposed agreement are agreed expressly or implicitly. Thus, an agreement to engage a servant some time next year, at a salary to be mutually agreed upon is a void agreement.

5. Wagering Agreements

What is a wager? Literally the word 'wager' means a 'a bet:' something stated to be lost or won on the result of a doubtful issue, and, therefore, wagering agreements are nothing but ordinary betting agreements. Thus where *A* and *B* mutually agree that if it rains today *A* will pay *B* Rs 100 and if it does not rain *B* will pay *A* Rs 100 *or* where *C* and *D* enter into an agreement that on tossing up a coin, if it falls head upwards *C* will pay *D* Rs 50 and if it falls tail upwards *D* will pay *C* Rs 50, there is a wagering agreement.

In *Thacker* vs *Hardy*[15] Cotton, L.J., described a 'wager' as follows: "The essence of gaming and wagering is that one party is to win and the other to lose upon a future event which at the time of the contract is of an uncertain nature — that is to say, if the event turns out one way *A* will lose; but if it turns out the other way he will win."

Possibly the most expressive and all-encompassing definition of a "wagering agreement" was given by Hawkins, J., in *Carlill* vs *Carbolic Smoke Ball Co.*:[16]

"A wagering contract is one by which two persons professing to hold opposite views touching the issue of a future uncertain event mutually agree that, dependent upon the determination of that event, one shall win from the other, and the other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum of stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract."

[15](1878), 4 QBD. 685.

[16](1892), 2 Q.B. 484.

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Certain aspects of the above definition require to be emphasised. In the first place, wager is a game of chance in which the contingency of either gain or loss is wholly dependent on an 'uncertain event.' An event may be uncertain, not only because it is a future event, but because it is not yet known to the parties. Thus a wager may be made upon the result of the cricket match which is to take place next month in Calcutta, or upon the result of an election which is over, if the parties do not know the result. Secondly, the parties to a wager must have no interest in the event's happening or non-happening except the winning or losing of the bet laid between them. It is here that wagering agreements differ from insurance contracts which are valid because parties have an interest to protect the life or property, and have, for that very reason, entered into the contract of insurance.

Essential features of a wager. The essentials of a wagering agreement may thus be summarised as follows:

(*a*) There must be a promise to pay money or money's worth.

(*b*) The promise must be conditional on an event happening or not happening.

(*c*) The event must be an uncertain one. If one of the parties has the event in his own hands, the transaction is not a wager.

(*d*) Each party must stand to win or lose under the terms of agreement. An agreement is not a wager if one party may only win and cannot lose, or if he may lose but cannot win, or if he can neither win nor lose.

(*e*) No party should have a proprietary interest in the event. The stake must be the only interest which the parties have in the agreement.

Agreements by way of wager, void. Section 30 lays down that "agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or entrusted to any person to abide the result of any game or other uncertain event on which any wager is made." Thus, where *A* and *B* enter into an agreement which provides that if England's cricket team wins the test match, *A* will pay *B* Rs 100, and if it loses *B* will pay Rs 100 to *A*, nothing can be recovered by the winning party under the agreement, it being a wager. Similarly, where *C* and *D* enter into a wagering agreement and each deposits Rs 100 with Z instructing him to pay or give the total sum to the winner, no suit can be brought by the winner for recovering the bet amount from Z, the stake-holder. Further, if Z had paid the sum to the winner, the loser cannot bring a suit, for recovering his Rs 100, either against the winner or against Z, the stake-holder, even if Z had paid after the loser's definite instructions not to pay. Of course the loser can recover back his deposit if he makes the demand before

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the stake-holder had paid it over to the winner (*Ratnakalli* vs *Vochalapu*[17]). But even such a deposit cannot be recovered by a loser in the States of Maharashtra and Gujarat where such an agreement is void and illegal.

The Section makes an *exception* in favour of certain prizes for horse racing by providing further that "This Section shall not be deemed to render unlawful a subscription, or contribution, or agreement to subscribe or contribute, made or entered into for or toward any plate, prize or sum of money, of the value or amount of five hundred rupees or upwards, to be awarded to the winner or winners of any horse race." Thus, a bet on a horse race carrying a prize of Rs 500 or more to the winners has been made valid under the exception. But with a view to protecting the poor persons from gambling, a bet on a horse race carrying a prize of less than Rs 500 remains a wager.

It is important to note that in the States of Maharashtra and Gujarat wagering agreements are, by a local statute, not only void but also illegal. As a result in these states the collateral transactions to wagering agreements become tainted with illegality and hence are void.

Special cases. We now turn to certain special cases in order to examine as to whether they are wagers:

Commercial transactions. Agreements for sale and purchase of any commodity or share market transactions, in which there is a genuine intention to do legitimate business *i.e.*, to give and take delivery of goods or shares, are not wagering agreements. If there is no such genuine intention and parties only want to gamble on the rise or fall of the market by paying or receiving the differences in prices only, the transaction would be a wagering agreement and therefore void. "In order to constitute a wagering contract, neither party should intend to perform the contract itself, but only to pay the differences"[18]

Lotteries. A lottery is a game of chance. Hence the lottery business is a wagering transaction. Such a transaction is not only void but also illegal because Section 294-A of the Indian Penal Code declares 'conducting of lottery' a punishable offence. If a lottery is authorised by the Government, the only effect of such permission is that the persons conducting the lottery (*i.e.*, the persons running the lottery and the buyer of lottery ticket) will not be guilty of a criminal offence, but the lottery remains a wager alright (*Dorabji Tata* vs *Lance*[19]).

Crossword puzzles. Where prizes depend upon a chance, it is a lottery and therefore a wagering transaction. Thus a crossword puzzle, in which prizes depend upon correspondence of the competitor's solution with a previously prepared solution, is a wager. But if prizes depend upon skill and intelligence, it is a valid transaction. Thus prize competitions which are

[17]A.I.R. (1928) Mad. 434.

[18]Pollock and Mulla, *Indian Contract Act*, 6th Ed., p. 234.

[19](1918) 42 Bom. 676.

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games of skill and in which an effort is made to select the best competitor *e.g.*, picture puzzles, literary competitions and athletic competitions are not wagers. Even in such competitions the amount of prize should not exceed Rs 1,000, otherwise they shall be wagers as per the provisions of the Prize Competition Act, 1955.

Insurance contracts. Insurance contracts are valid contracts even though they provide for payment of money by the insurer on the happening of a future uncertain event. Such contracts differ from wagering agreements mainly in three respects:

(*a*) The holder of an insurance policy must have an 'insurable interest' in the event upon which the insurance money becomes payable. Thus contracts of insurance are entered into to protect an interest. In a wagering agreement there is no interest to protect and the parties bet exclusively because they can thereby make some easy money.

(*b*) Contracts of insurance are based on scientific and actuarial calculation of risks, whereas wagering agreements are a gamble without any scientific calculation of risks.

(*c*) Contracts of insurance are regarded as beneficial to the public, whereas wagering agreements do not serve any useful purpose.

6. Agreements Contingent on Impossible Events

"Contingent agreements to do or not to do anything, if an impossible event happens, are void, whether the impossibility of the event is known or not to the parties to the agreement at the time when it is made." (Sec. 36)

ILLUSTRATIONS (to Sec. 36). (*a*) *A* agrees to pay *B* Rs 1,000 (as a loan) if two straight lines should enclose a space. The agreement is void.

(*b*) *A* agrees to pay *B* Rs. 1,000 (as a loan) if *B* will marry *A's* daughter, *C*. *C* was dead at the time of the agreement. The agreement is void.

7. Agreements to do Impossible Acts

"An agreement to do an act impossible in itself is void." (Sec. 56 Para 1)

ILLUSTRATIONS. *(a) A* agrees with *B* to discover treasure by magic. The agreement is void [Illustration (*a*) to Section 56].

(*b*) *A* agrees with *B* to run with a speed of 100 Kilometres per hour. The agreement is void.

No Restitution

The term 'restitution' means 'return' or 'restoration' of the benefit received from the plaintiff under the agreement. As per Section 65 no restitution of the benefit received is allowed in the case of expressly declared void agreements.[20]

[20]For details refer to Chapter 1.

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TEST QUESTIONS

1. Discuss briefly expressly declared void agreements under the Indian Contract Act.

2. Discuss the law relating to (*a*) agreements in restraint of marriage, and (*b*) uncertain agreements.

3. "An agreement in restraint of trade is void." Discuss the statement giving exceptions to it, if any.

4. What is a wager? Is an agreement by way of wager void or illegal? Is a contract of insurance a wager?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* agrees to sell all the goods manufactured by him in the ensuing season to *B*. In breach of the said agreement *A* sold some goods manufactured during the said season to *C*. Thereupon *B* sued *A* for breach of contract. Will *B* succeed?

[**Hint.** Yes, *B* will succeed because the agreement between him and *A* is valid as it aims to promote business and does not restrain it.]

2. *A* agrees to sell his cow to *B* for Rs 500 if the cow gives 6 kg milk every day, but for Rs 10 only if it fails to do so. The cow fails, whereupon *B* demands the cow for Rs. 10 as agreed. *A* refuses. *B* brings a suit against him. Will *B* succeed?

[**Hint.** No, *B* will not succeed as the transaction, though ostensibly a sale, is in reality a wager (*Brogden* vs *Marriott,* 5 LJ (CP) 302).]

3. *A* lends money to *B* to enable him to pay off the loss which he has sustained in a wagering transaction with *C*. Can *A* recover the money lent by him?

[**Hint.** *A* can recover, because an agreement collateral to a wagering agreement remains valid except in Maharashtra and Gujarat States where wagering agreements are illegal.]

4. *A* and *B* are partners in a business. They enter into a wagering agreement with a third party. On losing the bet *A* satisfies his own and also *B's* liability under the agreement. Can *A* claim from *B* the amount paid on his behalf?

[**Hint.** Yes, *A* can claim the amount from *B* because a wagering agreement is only void and not illegal and therefore a collateral contract can be enforced.]

5. *A* and *B* enter into a wagering agreement and deposit Rs 500 each with *C* instructing him to give the total sum to the winner. *A* wins. He sues *C* for the stake amount. *B* also sues *C* for a return of the stake deposited by him with *C*. Decide.

[**Hint.** *A* cannot recover the bet amount from *C* because the law will not assist in the enforcement of a wagering agreement. Both *A* and *B*, however, can recover the amount deposited by them, because it is clear from the facts of the case that the sum is still in the hands of *C*. Of course they cannot even recover their deposit money if the transaction took place in Maharashtra and Gujarat States where a wagering agreement is not only void but also illegal.]

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Chapter 8

Contingent Contracts

Definition

Section 31 of the Contract Act defines a contingent contract as follows: "A contingent contract is a contract to do or not to do something, if some event, *collateral* to such contract does or does not happen." Thus it is a contract, the performance of which is *dependent upon,* the happening or non-happening of an uncertain event, *collateral* to such contract.

ILLUSTRATION. *A* contracts to indemnify *B* upto Rs 20,000, in consideration of *B* paying Rs 1,000 annual premium, if *B*'s factory is burnt. This is a contingent contract.

Any ordinary contract can be changed into a contingent contract, if its performance is made dependent upon the happening or non-happening of an uncertain event, collateral to such contract. For example, the following are contingent contracts:

(a) A contracts to sell *B* 10 bales of cotton for Rs 20,000, if the ship by which they are coming returns safely.

(b) A promises to give a loan of Rs 1,000 to *B*, if he is elected the president of a particular association.

(c) A promises to pay Rs 50,000 to *B* if a certain ship does not return, of course after charging usual premium. (It is a contract of insurance.)

(d) C advances a loan of Rs 10,000 to *D* and *M* promises to *C* that if *D* does not repay the loan, *M* will do so. (It is a contract of guarantee.)

Contracts of insurance and contracts of indemnity and guarantee are popular instances of contingent contracts.

As the performance of a contract is made dependent upon a contingency, contingent contracts are also known as 'conditional' contracts. But in certain cases a contract may look like a 'conditional' contract, whereas in fact it may be simply an ordinary *absolute* contract where the promisor undertakes to perform the contract in all events. For example, where *A* promises to pay Rs 500 to *B*, a property broker, if *B* manages to get a two rooms accommodation for him at a rental of Rs 2,500 per month, it is not a contingent contract, though on the face of it, it appears like a conditional contract. It is an ordinary absolute contract because the uncertain event (namely, managing to get an accommodation) itself forms the consideration

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of the contract and is not a *collateral* event. Hence it must be clearly understood that in the case of contingent contracts the uncertain event must be *collateral* to such contracts.

Collateral event. According to Pollock and Mulla, a 'collateral event' means an event which is "neither a performance directly promised as part of the contract, nor the whole of the consideration for a promise."[1] Thus, where *C* contracts to pay Rs 100 to *D* for white-washing his house on the terms that no payment shall be made till the completion of the work, it is not a contingent contract, because the event (*D*'s completing the work) is not collateral to the contract, but is itself a reciprocal promise or is the very thing contracted for, and is thus an *integral part* of the contract. Similarly, a contract for the sale of goods wherein the seller agrees to give delivery of goods after a week provided the purchaser makes the payment within two days, is an absolute contract and not a contingent contract because the event (making payment by the buyer) is an *integral part* of the contract (a condition precedent) and not collateral to the contract.

In simple words, the collateral event is one which does not form part of consideration of the contract, and is independent of it. For example, *A* contracts to pay Rs 50,000 to *B*, a contractor, for constructing a building, provided the construction is approved by an architect. It is a contingent contract because the consideration of the promise to pay Rs 50,000, is the construction of the building, and the event, namely, approval by an architect, *is a collateral event,* which is independent of the consideration, and it is on the happening of this collateral event that the contract shall be enforced.

Essentials of Contingent Contract

From the forgoing discussion the following two essentials of a contingent contract become evident:

1. The performance of such a contract depends upon the happening or non-happening of some future uncertain event.
2. The future uncertain event is collateral *i.e.*, incidental to the contract.

Rules Regarding the Performance of Contingent Contracts

The rules regarding the performance of contingent contracts, as contained in Sections 32 to 36 of the Contract Act, are given below:

1. Contingent contracts to do or not to do anything, if an uncertain future event *happens,* cannot be enforced by law unless and until that event has happened. If the event becomes impossible, such contracts become void (Sec. 32).

[1] *Indian Contract Act* by Pollock and Mulla, p. 235.

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ILLUSTRATIONS (to Sec. 32). *(a) A* makes a contract with *B* to buy *B*'s horse if *A* survives *C*. The contract cannot be enforced by law unless and until *C* dies in *A*'s lifetime.

(b) A makes a contract with *B* to sell a horse to *B* at a specified price, if *C*, to whom the horse has been offered, refuses to buy it. The contract cannot be enforced by law unless and until *C* refuses to buy the horse.

(c) A contracts to pay *B* a sum of money (as loan) when *B* marries *C*. *C* dies without being married to *B*. The contract becomes void.

2. Contingent contracts to do or not to do anything, if an uncertain future event *does not happen,* can be enforced when the happening of that event becomes impossible, and not before (Sec. 33).

ILLUSTRATION (to Sec. 33). *A* agrees to pay *B* a sum of money (as insurance claim) if a certain ship does not return (of course after charging premium). The ship is sunk. The contract can be enforced when the ship sinks.

3. If a contract is contingent *upon how a person will act at an unspecified time,* the event shall be considered to become impossible when such person does anything which renders it impossible that he should so act within any definite time, or otherwise than under further contingencies (Sec. 34).

ILLUSTRATION (to Sec. 34). *A* agrees to pay *B* a sum of money (as loan) if *B* marries *C*. *C* marries *D*. The marriage of *B* to *C* must now be considered impossible, although it is possible that *D* may die and that *C* may afterwards marry *B*. [If later *B* actually marries *C* (the *D*'s widow), it will not revive the old obligation of *A* to pay the sum, because that came to an end when *C* married *D*].

4. Contingent contracts to do or not to do anything, *if a specified uncertain event happens within a fixed time,* becomes void, if, at the expiration of the time fixed, such event has not happened, or if, before the time fixed, such event becomes impossible [Sec. 35 (1)].

ILLUSTRATION (to Sec. 35). *A* promises to pay *B* a sum of money (as loan) if a certain ship returns within a year. The contract may be enforced if the ship returns within the year, and becomes void if the ship is burnt within the year or if the ship does not return within the year.

5. Contingent contracts to do or not to do anything, *if a specified uncertain event does not happen within a fixed time,* may be enforced by law when the time fixed has expired and such event has not happened, or, before the time fixed has expired, if it becomes certain that such event will not happen [Sec. 35 (2)].

ILLUSTRATION (to Sec. 35). *A* promises to pay *B* a sum of money (as insurance claim) if a certain ship does not return within a year. The contract may be enforced if the ship does not return within the year, or is burnt within the year.

6. Contingent agreements to do or not to do anything, if an impossible event happens, are void, whether the impossibility of the event is known or not to the parties to the agreement at the time when it is made (Sec. 36).

ILLUSTRATIONS (to Sec. 36). *(a) A* agrees to pay *B* Rs. 1,000 (as a loan),

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if two straight lines should enclose a space. The agreement is void.

(b) *A* agrees to pay *B* Rs 1,000 (as a loan), if *B* will marry *A*'s daughter *C*. *C* was dead at the time of the agreement. The agreement is void.

Difference between a Contingent Contract and a Wagering Agreement

The main points of distinction between the two are as under:

1. A contingent contract is a valid contract but a wagering agreement is absolutely void.

2. In a contingent contract the parties have real interest in the occurrence or non-occurrence of the event *e.g.,* insurable interest in the property insured, but in a wager the parties are not interested in the occurrence of the event except for the winning or losing the bet amount.

3. In a contingent contract the future uncertain event is merely collateral whereas in a wagering agreement the uncertain event is the sole determining factor of the agreement.

TEST QUESTIONS

1. Define the term "contingent contracts". Discuss the rules relating to the performance of contingent contracts.

2. *(a)* What are the essential characteristics of a contingent contract?

(b) To what extent the impossibility of the contingency affects the performance of the contract?

3. Distinguish between a contingent contract and a wagering agreement. What are the rules relating to the performance of contingent contracts?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* agrees to construct a building for *B* for Rs 2 lakhs, on the terms that no payment shall be made till the completion of the work. Is this a contingent contract?

[Hint. No, this is not a contingent contract because the uncertain event (*i.e.,* *A*'s completing the work) is not collateral to the contract but is the very thing contracted for, and is thus an integral part of the contract.]

2. *A* agrees to sell land to *B* at a price to be fixed by *C*. *C* refuses to fix the price. Is the contract enforceable?

[Hint. No, the contract is not enforceable because by *C*'s refusal to fix the price, the agreement becomes void for uncertainty in terms.]

3. *A* promises to pay *B* for his services whatever *A* himself will think right or reasonable. Later, being dissatisfied with the payment made, *B* sues *A*. Decide.

[Hint. *B*'s suit will not be admitted by the Court because if the performance of a promise is contingent upon the mere will and pleasure of the promisor, there is no contract. The rule of law being "agreements, the meaning of which is not certain, or capable of being made certain, are void" (Sec.29).]

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Chapter 9

Performance of Contracts

"Performance of Contract" means fulfilling of their respective legal obligations created under the contract by both the promisor and the promisee. When a contract is duly performed by both the parties, the contract comes to a happy ending and nothing more remains. Performance by all the parties of the respective obligations is the normal and natural mode of discharging or terminating a contract.

We shall here discuss "various rules" as to the performance of contracts.

Who Can Demand Performance?

It is only the promisee who can demand performance of the promise under a contract, for, the general rule is that "a person cannot acquire rights under a contract to which he is not a party" (*T.G. Venkataraman* vs *State of Madras*[1]). A third party cannot demand performance of the contract even if it was made for his benefit.[2]

In case of the death of the promisee, his legal representatives are entitled to enforce the performance of the contract against the promisor.

ILLUSTRATIONS. *(a) A* promises *B* to pay *C* a sum of Rs 1,000. The person who can demand performance is *B* and not *C*. If *A* does not pay the amount to *C*, *C* cannot take any action against *A*. It is only *B* who can take action against *A*. On the death of *B*, *B's* legal representatives are entitled to enforce the promise against *A*.

(b) A mortgaged his land to *B*, part of the consideration for the same being *B*'s promise to discharge a debt of *A* to *C*. *B* did not pay to *C*. It was held that *C* was a stranger to the contract and could not sue *B* for the payment of the debt (*Babu Ram* vs *Dhan Singh*[3]).

By Whom Contracts must be Performed?

1. **By the promisor himself.** In the case of a contract involving per-

[1]A.I.R. (1970) S.C. 508.

[2]There are, however, certain exceptions to the general rule: where "*a stranger to a contract can sue.*" These have already been discussed in Chapter 3.

[3]A.I.R. (1957) Punj. 169.

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sonal skill, taste or credit; *e.g.,* a contract to paint a picture, a contract of agency or service; the promisor must himself perform the contract. Section 40 states thus, "if it appears from the nature of the case that it was the intention of the parties to any contract that any promise contained in it should be performed by the promisor himself, such promise must be performed by the promisor."

ILLUSTRATION. *A* promises to paint a picture for *B*. *A* must perform this promise personally [Illustration (*b*) to Section 40].

2. **By the promisor or his agent.** In the case of a contract of impersonal nature; *e.g.,*a contract of sale of goods or a contract to lend a sum of money; the promisor himself or his agent may perform the contract [Section 40 Clause (2)].

ILLUSTRATION. *A* promises to pay *B* a sum of money. *A* may perform this promise, either by personally paying the money to *B* or by causing it to be paid to *B* by another [Illustration (*a*) to Section 40].

3. **By the legal representatives.** In case of the death of the promisor before performance, the liability of performance falls on his legal representatives, unless a contrary intention appears from the contract [Section 37 Clause (2)]. Thus, in the case of contracts involving personal skill, the heirs or legal representatives of a deceased promisor are not bound to perform the contract. Such contracts come to an end on the death of the promisor. The rule of law is: "a personal cause of action comes to an end with the death of the person concerned". In the case of contracts not involving personal considerations, the legal representatives are bound to perform the contract. But their liability is limited to the estate of the deceased which has come to their hands, in case of breach of contract. They are not personally liable.

ILLUSTRATIONS (to Sec.37). *(a) A* promises to paint a picture for *B* by a certain day at a certain price. *A* dies before the day. The contract cannot be enforced either by *A*'s representatives or by *B*.

(b) A promises to deliver goods to *B* on a certain day on payment of Rs 1,000. *A* dies before that day. *A*'s representatives are bound to deliver the goods to *B*, and *B* is bound to pay the Rs 1,000 to *A*'s representatives.

4. **Performance by a third person.** Section 41 lays down that if a promisee accepts performance of the promise from a third person, he cannot afterwards enforce it against the promisor. Thus, where a promisee accepted lesser amount from a third party in full satisfaction of his claim, it was held that he cannot enforce the promise against the promisor (*Lala Kapurchand* vs *Mir Nawab Azamjah*[4]). Notice that under this Section performance of the promise by a stranger, once accepted by the promisee, discharges the promisor, although the latter has neither authorised nor ratified the act of the third party.

[4]A.I.R. (1963) S.C. 250.

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Performance of Joint Promises

Joint promises may take any of the following shapes:

(i) where several joint promisors make a promise with a single promisee, *e.g., A, B* and *C* jointly promise to pay Rs 3,000 to *D*, or

(ii) where a single promisor makes a promise with several joint promisees, *e.g., P* promises to pay Rs 3,000 to *Q* and *R* jointly, or

(iii) where several joint promisors make a promise with several joint promisees, *e.g., A, B* and *C* jointly promise to pay Rs 3,000 to *P,Q* and *R* jointly.

We have earlier seen as to "who can demand performance," and "by whom contracts must be performed," when there is an agreement between a single promisor and a single promisee. We now attempt to answer the aforesaid questions in the case of joint promises.

Who can demand performance of joint promises? The answer to this question is found in Section 45 which provides that when a promise is made to several persons jointly, then, unless a contrary intention appears from the contract, the right to claim performance rests with all the promisees jointly and a single promisee cannot demand performance. When any one of the promisees dies, the right to claim performance rests with the legal representatives of such deceased person jointly with the surviving promisees. When all the promisees are dead, the right to claim performance rests with the legal representatives of all jointly. In brief, so long as all the joint promisees are alive, the right to claim performance rests with all of them jointly and on the death of any promisee his legal representatives step into his shoes.

ILLUSTRATION (to Sec. 45). *A,* in consideration of Rs 5,000, lent to him by *B* and *C*, promises *B* and *C* jointly to repay them that sum with interest on a day specified. *B* dies. The right to claim performance rests with *B*'s representative jointly with *C* during *C*'s life and after the death of *C* with the representatives of *B* and *C* jointly.

It is worth noting that under the terms of the Section if a promisor makes the payment to one of the several joint promisees, it does not operate as a complete discharge of the debt (*Govindlal* vs *Firm Thakurdas*[5]).

By whom joint promises must be performed? The rules on the subject, as contained in Sections 42 to 44 of the Contract Act, are as follows:

1. *All promisors must jointly fulfil the promise.* When two or more persons have made a joint promise (*e.g.,* signed a promissory note jointly), then, unless a contrary intention appears by the contract, all such persons must jointly fulfil the promise. When any one of the joint promisors dies, his legal representatives must, jointly with the surviving promisors, fulfil the promise. On the death of all the original promisors, the legal represen-

[5]A.I.R. (1974) Bom. 164.

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tatives of all of them jointly must fulfil the promise (Sec. 42).

The above rule is of course subject to the following usual conditions:

(a) Contracts involving personal skill, *e.g.,* to paint a picture, come to an end on the death of any of the joint promisors and the liability of performance does not fall on the legal representatives.

(b) Wherever the legal representatives are made liable to perform the promise, they are not personally liable. Their liability is limited to the assets inherited by them.

2. *Any one of joint promisors may be compelled to perform.* When two or more persons make a joint promise, the promisee is entitled, in the absence of express agreement to the contrary, to compel any one or more of such joint promisors to perform the whole of the promise (Sec.43, Para 1). In other words, according to the Section the liability of joint promisors is "joint and several" as against the promisee, unless there is a contract to the contrary. For example, *A, B* and *C* jointly promise to pay *D* Rs 3,000. *D* may compel either *A* or *B* or *C* or all or any two of them to pay him Rs 3,000.

In case of death of original debtor, if the debt falls upon a number of heirs, promisee must bring the suit against all heirs collectively, because the liability is only joint and not several in case of co-heirs. Co-heirs are not joint promisors.

It will be pertinent to discuss as to what is the effect of a "decree" obtained against only one or two of the joint promisors? The Calcutta High Court has held[6] that a decree against some only of the joint promisors constitutes a bar to a second suit against other co-promisors, even if the promisee fails to realise the whole of the decretal amount, for, his claim merges in the decree. Thus in the above example, if *D* sues only *A* and could recover only Rs 1,500 from him, on a decree of Rs 3,000, he cannot as per the above verdict, sue for the balance other joint promisors later on. But the Madras High Court has dissented[7] from the above decision. It is of the view that as the liability of joint promisors is joint and several under Section 43, a judgment obtained against some only of the joint promisors and remaining unsatisfied is no bar to a second suit on the contract against the other joint promisors. Thus, according to the Madras High Court verdict, in our above example *D* can sue the remaining joint promisors later on for the unsatisfied portion of the decree. The Madras High Court's view seems logical. In fact a decision of the Supreme Court is required to settle

[6]In *Phani Bhushan* vs *Rajendra,* A.I.R. (1947) Cal. 11. The effect of the decision is that the liability of joint promisors is *"joint and alternative."*

[7]In *T.R. Chettiar* vs *M.K. Chettiar,* A.I.R. (1970) Mad. 337. The effect of the decision is that the liability of joint promisors is *"joint and several."*

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the law on the point in question.

3. *Right of contribution inter-se between joint promisors.* If one of several joint promisors is made to perform the whole contract, he may require equal contribution from the other joint promisors, unless a contrary intention appears from the contract (Sec. 43, Para 2). Thus, in our example, if *A* is compelled to pay the entire amount of Rs 3,000, he can realise from *B* and *C* Rs 1,000 each.

4. *Sharing of loss by default in contribution.* If any one of the joint promisors makes a default in making contribution, if any, the remaining joint promisors must bear the loss arising from such default in equal shares (Sec.43, Para 3). Thus, in our example, if *A* is compelled to pay the whole and *C* is unable to pay anything, *A* is entitled to receive Rs 1,500 from *B*. If *C*'s estate is able to pay one-half of his share, *A* is entitled to receive Rs 500 from *C's* estate and Rs 1,250 from *B* [Illustrations *(b)* and *(c)* to Section 43].

5. *Effect of release of one joint promisor.* In case of joint promise, if one of the joint promisors is released from his liability by the promisee, his liability to the promisee ceases but this does not discharge the other joint promisors from their liability; neither does it free the joint promisor so released from his liability to contribute to the other joint promisors (Sec.44).

Assignment of Contracts

Assignment of contract means transfer of contractual rights and liabilities to a third party with or without the concurrence of the other party to the contract. By virtue of assignment, as assignee can bring an action on his own initiative (without making the assignor a party to the suit) against the other party to the contract. The Indian Contract Act contains no specific provisions dealing with assignment of contracts. But the law on the subject is well settled and the rules which have been applied by Courts in India in this regard are as follows:

1. Contracts involving personal skill, taste or credit, *e.g.,* a contract to paint a picture, a contract to perform a service or to marry, cannot be assigned.

2. The obligations (*i.e.,* the liabilities) under a contract cannot be assigned except with the consent of the promisee, and when such consent is given, it is really a "novation" resulting in a substitution of liabilities. For instance, if *X* owes *Y* Rs. 200, he cannot transfer the liability to *Z* and force *Y* to collect his money from *Z*. But if *Y* agrees to accept *Z* as his debtor in place of *X*, there is "novation" (*i.e.*, the old contract is substituted by new contract) and the liability to pay the debt stands transferred from *X* to *Z*.

3. The rights and benefits under a contract are assignable unless the contract is of personal nature or the rights are incapable of assignment

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either under the law or under an agreement between the parties, and the assignee can demand performance against the other contracting party. This is so because it makes no difference to the party bound by that obligation, whether he is called upon to perform it in favour of the original party or in favour of the assignee. But the assignee takes the assignment 'subject to all equities', if any. This means that the debtor may plead against the assignee all defences that he could have pleaded against the assignor. For instance, if one of the two parties is induced to enter into a contract by fraud, and the fraudulent party assigns his interest in the contract to a *bonafide* third party for value, the defrauded party is entitled to rescind the contract in equity in spite of its assignment to an innocent party (*Graham* vs *Johnson*[8]).

An "actionable claim," *i.e.,* a claim to any debt, or to any beneficial interest in movable property not in possession of the claimant, upon which legal action can be taken, can always be assigned but the assignment in order to be complete and effectual must be made by an instrument in writing. Although notice of assignment to the debtor is not required under law,[9] nevertheless it is in the interest of the assignee to give notice to the debtor because in the absence of notice the assignee is bound by any payments which the debtor may make to the assignor in ignorance of the assignment. There are special provisions for assigning certain classes of contracts, *e.g.*, negotiable instruments, life and marine insurance policies.

4. Assignment by operation of law takes place in cases of death and insolvency. Upon the death of a party his rights and liabilities under a contract devolve upon his heirs and legal representatives (except in the case of a contract involving personal qualifications). In case of insolvency, all rights and liabilities of the insolvent pass to the Official Assignee or Receiver, as the case may be.

Order of Performance of Reciprocal Promises

Promises which form the consideration for each other are called "reciprocal promises" or "mutual promises." It is common knowledge that "bilateral contracts,"[10] where both contracting parties have to perform their promises, involve "mutual promises" amongst the parties. In such contracts each party gives a promise, in return for a promise; *e.g.*, *A,* promises to sell certain goods to *B* and *B*, in return promises to pay the price thereof to *A,* and there is an obligation on each party to perform his own promise and

[8](1869), L.R. 8 Eq. 36.

[9]Section 130, *The Transfer of Property Act.*

[10]For detailed discussion on "Unilateral" and "Bilateral" contracts, please refer to Chapter 1—Heading: *Kinds of Contracts from the point of view of the Extent of Execution.*

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to accept performance of other's promise.

Reciprocal promises may be classified into three categories: (1) Mutual and Independent, (2) Mutual and Dependent, and (3) Mutual and Concurrent. Sections 51 to 54 of the Contract Act lay down the rules regarding the order of performance of reciprocal promises, which are stated below:

1. **Mutual and Independent.** Where each party must perform his promise *independently* without waiting for the performance or the willingness to perform of the other, the promises are 'mutual and independent.' According to Section 52, such promises must be performed in the order expressly fixed by the contract, and where the order is not expressly fixed, they must be performed in that order which the nature of the transaction requires.

ILLUSTRATIONS. *(a) A,* promises to deliver certain goods to *B* on 10th April and *B* promises to pay the price in advance on 1st April and on default to pay interest @ 15 per cent per annum from 1st April till the date of payment. In this case *A*'s promise to deliver goods is independent of *B*'s promise to pay the price. Even if *B* does not pay the price on 1st April, *A* must deliver the goods on 10th April. *A* can, of course, sue *B* for the payment of price and damages.

(b) A and *B* contract that *A* shall build a house for *B* at a fixed price. *A's* promise to build the house must be performed before *B*'s promise to pay for it [Illustration *(a)* to Section 52].

Whether the promises are such as are to be 'independently performed is often a question of construction depending on the intention of the parties collected from the agreement as a whole or from what 'the nature of transaction requires.'

2. **Mutual and Dependent.** Where the performance of the promise by one party depends on the prior performance of the promise by the other party, the promises are 'mutual and dependent.' Section 54 provides for such promises and lays down that if the promisor who is required to perform his promise in the first place, fails to perform it, such promisor cannot claim the performance of the reciprocal promise, and must make compensation to the other party to the contract for any loss which such other party may sustain by the non-performance of the contract.

ILLUSTRATIONS. *(a) A* contracts with *B* to execute certain builder's work for a fixed price, *B* supplying the scaffolding and timber necessary for the work. *B* refuses to furnish any scaffolding or timber, and the work cannot be executed. *A* need not execute the work, and *B* is bound to make compensation to *A* for any loss caused to him by the non-performance of the contract [Illustration *(b)* to Section 54].

(b) A promises *B* to sell him one hundred bales of merchandise to be delivered next day, and *B* promises *A* to pay for them within a month. *A* does not deliver according to his promise. *B*'s promise to pay need not be performed and *A* must make compensation [Illustration (*d*) to Section 54].

3. **Mutual and Concurrent.** Where the two promises are to be per-

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formed simultaneously, they are said to be 'mutual and concurrent.' According to Section 51, in the case of such promises the promisor need not perform his promise unless the promisee is ready and willing to perform his reciprocal promise.

ILLUSTRATIONS (to Sec.51). *(a)* *A* and *B* contract that *A* shall deliver goods to *B* to be paid for by *B* on delivery. Here the promises are 'mutual and concurrent' and therefore *A* need not deliver the goods, unless *B* is ready and willing to pay for the goods on delivery; and *B* need not pay for the goods, unless *A* is ready and willing to deliver them on payment.

(b) *A* and *B* contract that *A* shall deliver goods to *B* at a price to be paid by instalments, the first instalment to be paid on delivery. *A* need not deliver, unless *B* is ready and willing to pay the first instalment on delivery. *B* need not pay the first instalment, unless *A* is ready and willing to deliver the goods on payment of the first instalment.

4. **Consequences where a party prevents performance.** "When a contract contains reciprocal promises and one party to the contract prevents the other from performing his promise, the contract becomes voidable at the option of the party so prevented; and he is entitled to compensation from the other party for any loss which he may sustain in consequence of the non-performance of the contract." (Sec.53)

ILLUSTRATION (to Sec. 53). *A* and *B* contract that *B* shall execute certain work for *A* for Rs 1,000. *B* is ready and willing to do the work accordingly, but *A* prevents him from doing so. The contract becomes voidable at the option of *B*, and if he elects to rescind it, he is entitled to recover from *A* compensation for any loss which he has incurred by its non-performance.

Time and Place for Performance

Sections 46 to 50 and 55 of the Contract Act lay down the rules regarding the time and place for performance of a contract, which are summarised below:

Where prescribed by the promisee. Where the time and place are prescribed by the promisee, the performance of the contract must be at the specified time and place.

Where not prescribed by the promisee. If no time and place are prescribed by the promisee, then the contract must be performed:

(a) Within a reasonable time, on a working day and within the usual hours of business. The question, "what is a reasonable time" is, in each particular case, a question of fact. It depends either on special circumstances of each particular case or the usage of trade or the intention of parties at the time of entering into contract.

ILLUSTRATION (to Sec. 47). *A* promises to deliver goods at *B*'s warehouse on 1st January. On that day *A* brings the goods to *B*'s warehouse, but after the usual hour for closing it, and they are not received. *A* has not performed his promise.

(b) At proper place e.g., at godown or shop, and not at a public meeting

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or a fair. "What is a proper place" is, in each particular case, a question of fact. Generally speaking the promisor must ask the promisee where he would like the contract to be performed, and to perform it at such place (Sec. 49).

ILLUSTRATION (to Sec.49). *A* undertakes to deliver a thousand maunds of jute to *B* on a fixed day. *A* must apply to *B* to appoint a reasonable place for the purpose of receiving it and must deliver it to him at such place.

Effects of failure to perform a contract within the stipulated time. Section 55 deals with the subject and lays down the following rules:

1. Where "time is of the essence of the contract" and there is failure to perform within the fixed time, the contract (or so much of it as remains unperformed) becomes voidable at the option of the promisee. He may rescind the contract and sue for the breach.

2. Where "time is *not* of the essence of the contract," failure to perform within the specified time does not make the contract voidable. It means that in such a case the promisee cannot rescind the contract and he will have to accept the delayed performance. But he would be entitled to claim compensation from the promisor for any loss caused to him by the delay. This rule is, however, subject to the condition that the promisor should not delay the performance *beyond a reasonable time,* otherwise the contract will become voidable at the option of the promisee.

3. In case of a contract voidable on account of the promisor's failure to perform his promise within the agreed time or within a reasonable time, as the case may be, if the promisee, instead of rescinding the contract, accepts the delayed performance, he cannot afterwards claim compensation for any loss caused by the delay, unless, at the time of accepting the delayed performance, he gives notice to the promisor of his intention to do so.

When is the time the essence of the contract? "Time is of the essence of the contract," *(i)* if the parties to the contract have expressly agreed to treat it as such, or *(ii)* if the nature of transaction and the intention of parties were such that the performance within a limited time was necessary. Even where a time is specified for the performance of a certain promise, 'time may not be of the essence of the contract" and one has to look at the nature and construction of the contract and the intention of the parties in order to ascertain whether "time is of the essence of the contract" or not. It is well settled that unless a different intention appears from the terms of the contract, ordinarily in commercial contracts the time of delivery of goods is of the essence of the contract but not the time of payment of the price (*Wasoo Enterprises* vs *J.J. Oil Mills*[11]). This is so because there are great chances of rapid market fluctuations and also because after entering into a contract

[11]A.I.R. (1968) Guj. 57.

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the businessman, on that basis, may enter into other contracts with other persons which cannot be fulfilled unless he receives the delivery of goods under the contract. In contracts for the purchase of land, usually time is not of the essence of the contract because land values do not frequently fluctuate (*G. Pillai* vs *P. Nadar*[12]).

Mode or manner of performance. "The performance of any promise may by made in any manner,... which the promisee prescribes or sanctions" (Sec. 50). The promisor must perform the promise in strict accordance with the terms of the contract or instructions from the promisee. He has no right to substitute, for what he has been directed, something else, even if the substitute may be more beneficial to the promisee.

ILLUSTRATIONS (to Sec. 50). *(a) B* owes *A* Rs 2,000. *A* desires *B* to pay the amount to *A*'s account with *C*, a banker. *B*, who also banks with *C*, orders the amount to be transferred from his account to *A*'s credit, and this is done by *C*. Afterwards, and before *A* knows of the transfer, *C* fails. There has been a good payment by *B*.

(b) A desires *B*, who owes him Rs 100, to send him a note for Rs 100 by post. The debt is discharged as soon as *B* puts into the post a letter containing the note duly addressed to *A*.

Appropriation of Payments

When a debtor, who owes several debts to the same creditor, makes a payment which is insufficient to satisfy the whole indebtedness, the question arises, "as to which of the debts the payment is to be applied?" Sections 59 to 61 of the Contract Act answer this question and lay down the following rules:

1. **Debtor's express instructions must be followed.** Appropriation is a right given to the debtor for his benefit. Thus if the debtor expressly states that the payment made by him is to be applied to the discharge of some particular debt, the creditor must act accordingly otherwise he should not accept the payment.

2. **Debtor's implied intention must be followed.** If there are no express instructions, then debtor's implied intention should be gathered from the circumstances attending the payment and appropriation must be done accordingly.

ILLUSTRATIONS (to Sec. 59). *(a) A* owes *B*, among other debts Rs 1,000 upon a promissory note which falls due on the 1st June. He owes *B* no other debt of that amount. On the 1st June *A* pays to *B* Rs 1,000. The payment is to be applied to the discharge of the promissory note.

(b) A owes to *B*, among other debts, the sum of Rs 567. *B* writes to *A* and demands payment of this sum. *A* sends to *B* Rs 567. This payment is to be applied

[12](1967), 1 S.C.R. 227.

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to the discharge of the debt of which *B* had demanded payment.

3. **Appropriation by creditor.** If there is no express or implied direction by the debtor regarding appropriation, then the creditor has got the option to apply the payment to any debt lawfully due from the debtor, including a debt which is barred by the Limitation Act.

4. **Appropriation by law.** Where neither the debtor nor the creditor has made any appropriation, then according to law, the payment is to be applied in discharge of the debts in order of time, whether or not they are time-barred. If the debts are of equal standing, the payment shall be applied in discharge of each proportionately.

5. **When principal and interest both due.** If a payment has been made without expressly stating whether it is towards interest or principal, payment is to be applied towards interest first, and then the balance to principal (*Srinivasulu* vs *Kondappa*[13]).

It may be emphasised that if the creditor accepts the payment, he must follow the above rules of appropriation otherwise he must refuse to accept the payment.

Contracts which Need not be Performed

The circumstances under which contracts need not be performed are as follows:

1. If parties to a contract agree to 'Novation,' 'Rescission' or 'Alteration', the original contract need not be performed (Section 62). In such cases the original contract disappears and is substituted by a new contract.[14]

2. If parties to a contract agree to dispense with or remit performance of promise either wholly or in part, the original contract stands discharged (Sec. 63). This is technically called as 'Remission.'

3. When a person at whose option a contract is voidable rescinds it, the other party thereto need not perform his promise (Sec.64).

4. If any promisee neglects or refuses to afford the promisor reasonable facilities for the performance of his promise, the promisor is excused for the non-performance of the contract (Sec. 67). For instance, *A* contracts with *B* to repair *B*'s house. *B* neglects or refuses to point out to *A* the places in which his house requires repair. *A* is excused for the non-performance of the contract, if it is caused by such neglect or refusal (Illustration to Sec. 67).

[13](1960), A.P. 174. See also *Harishchandra* vs *Kailashchandra*, A.I.R. (1975), Raj. 15.

[14]For details see chapter on *Discharge of Contracts*.

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TEST QUESTIONS

1. What do you understand by performance of a contract? State who can demand performance and by whom contracts must be performed?

2. State with illustrations the provisions of the Indian Contract Act relating to the devolution of joint rights and liabilities.

3. What are reciprocal promises? State the provisions of the Indian Contract Act which deal with the order of performance of reciprocal promises.

4. (*a*) Discuss the law relating to assignment of contracts.

(*b*) Write a note on "Time is of the essence of the contract."

5. (*a*) State the rules relating to appropriation of payment made by a debtor to his creditor.

(*b*) State and discuss the circumstances under which contracts need not be performed.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *P*, *Q* and *R* jointly promise to pay *Z* Rs 3,000. *P* and *Q* are not traceable. Can *Z* compel *R* to pay him in full?

[**Hint.** Yes, *Z* can compel *R* to pay him the full amount because the liability of joint promisors is 'joint and several' under Section 43.]

2. A firm consisting of two partners *A* and *B*, owes a sum of Rs 5, 000 to *C*. *C* filed a suit to recover the sum against *A* only and obtained a decree. The decree remains partially unsatisfied and *C* could recover from *A* Rs 3,000 only. *C* now wants to file a suit against *B* for the balance of Rs 2,000. Advise *C*.

[**Hint.** *C* can file a suit against. *B* for recovering the balance amount because the liability of joint promisors is 'joint and several' as per Sec. 43. But according to Calcutta High Court *C* cannot file the suit against *B* for the balance amount because in that Court's opinion once a judgment has been obtained, *C*'s claim merges in the decree.]

3. *A* borrows Rs 3,000 from *B*, C and *D*. When the debt becomes due *A* tenders it to *B* who accepts it. Is *A* discharged by the payment?

[**Hint.** *A* is not discharged by the payment because under the terms of Section 45 a payment to one of several joint promisees does not operate as a complete discharge of a debt (*Govindlal* vs *Firm Thakurdas*, A.I.R. 1974 Bom. 174).]

4. *A* and *B* execute a promissory note in favour of *X* and *Y* for Rs 4,000. Will *X* succeed if he alone sues *A* on the pronote?

[**Hint.** *X* will not succeed if he sues alone. *Y* must join him because according to Section 45 the right to claim performance rests with all the promisees jointly and a single promisee cannot demand performance.]

5. *A* obtains two loans of Rs 25,000 each from a bank, one of which is guaranteed by *B*. *A* sends the bank a sum of Rs 30,000 without any direction regarding appropriation towards the loans. The bank appropriates Rs 25,000 towards the loan not guaranteed by *B* and Rs 5,000 only towards the loan guaranteed by *B*. *B* objects to such appropriation. Can he succeed?

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[**Hint.** *B* cannot succeed. In the absence of any express or implied instructions from the debtor regarding appropriation, the creditor is entitled to apply the payment to any of the two debts and hence the appropriation done by the bank is perfectly valid and binding, as per Section 60.]

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Chapter 10

Discharge of Contract

When the rights and obligations arising out of a contract are extinguished, the contract is said to be discharged or terminated. A contract may be discharged in any of the following ways:

1. By performance—actual or attempted.
2. By mutual consent or agreement.
3. By subsequent or supervening impossibility or illegality.
4. By lapse of time.
5. By operation of law.
6. By breach of contract.

Discharge by Performance

When a contract is duly performed by both the parties, the contract comes to a happy ending and nothing more remains. The contract, in such a case, is discharged or terminated by due performance. But if one party only performs his promise, he alone is discharged. Such a party gets a right of action against the other party who is guilty of breach.

Performance of a contract is the principal and most usual mode of discharge of a contract. Performance may be: (1) Actual performance; or (2) Attempted performance or Tender.

1. **Actual performance.** When each party to a contract fulfils his obligation arising under the contract within the time and in the manner prescribed, it amounts to actual performance of the contract and the contract comes to an end or stands discharged.

2. **Attempted performance or tender.** When the promisor offers to perform his obligation under the contract, but is unable to do so because the promisee does not accept the performance, it is called "attempted performance" or "tender." Thus "tender" is not actual performance but is only an "offer to perform" the obligation under the contract. A *valid tender* of performance is equivalent to performance.

Essentials of a valid tender. A valid tender or offer of performance must fulfil the following conditions:[1]

[1]As per Section 38 and Judicial decisions.

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1. It must be *unconditional.* A conditional tender is no tender. For example, *A*, who is a debtor of company *B*, offers to pay if shares are allotted to him at par. It is no tender.

2. It must be made at *proper time and place.* A tender before or after the due date *or* at a place other than agreed upon is not a valid tender. For example, *A* is a tenant of *B*. He offers him rent at a marriage party. *B* is not bound to accept as the tender is not made at a proper place.

3. It must be of the *whole obligation* contracted for and not only of the part. Thus deciding of his own to pay in instalments and offering the first instalment was held an invalid tender as it was not of the whole amount due (*Behari Lal* vs *Ram Gulam*[2]).

4. If the tender relates to delivery of goods, it must give a *reasonable opportunity to the promisee for inspection of goods* so that he may be sure that the goods tendered are of contract description.

5. It *must be made by a person* who is in a position and is willing to perform the promise. A tender by a minor or idiot is not a valid tender.

6. It *must be made to the proper person i.e.,* the promisee or his duly authorised agent. Tender made to a stranger is invalid.

7. If there are several joint promisees, an offer to any one of them is a valid tender. (But the actual payment must be made to all joint promisees, and not to any one of them, for a valid discharge of the contract, for, Section 45 provides that when a promise is made to two or more persons jointly, the right to claim performance rests with all of them jointly.)

8. In case of tender of money, exact amount should be tendered in the legal tender money. Tendering a smaller or larger amount is an invalid tender *e.g.*, tendering Rs 100 currency note to a conductor of a bus for a two rupees ticket is not a valid tender. Similarly, a tender by a cheque is invalid as it is not legal tender but if the creditor accepts the cheque, he cannot afterwards raise an objection.

Effect of refusal to accept a valid tender (Sec 38). The effect of refusal to accept a properly made "offer of performance" is that the contract is deemed to have been performed by the promisor *i.e.*, tenderer, and the promisee can be sued for breach of contract. A valid tender, thus, discharges the contract.

Exception. Tender of money, however, does not discharge the contract. The money will have to be paid even after the refusal of tender, of course without interest from the date of refusal. In case of a suit, cost of defence can also be recovered from the plaintiff, if tender of money is proved (*Jagat Tarini* vs *Naba Gopal*[3]).

[2](1902), 24 All. 461.
[3](1907), 34 Cal. 305.

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Discharge by Mutual Consent or Agreement

Since a contract is created by means of an agreement, it may also be discharged by another agreement between the same parties. Sections 62 and 63 deal with this subject and provide for the following methods of discharging a contract by mutual agreement:

1. **Novation.** "Novation occurs when a new contract is substituted for an existing contract, either between the same parties or between different parties, the consideration mutually being the discharge of the old contract." If parties are not changed then the nature of the obligation (*i.e.*, material terms of the contract) must be altered substantially in the new substituted contract, for, a mere variation of some of the terms of a contract, while the parties remain the same, is not "novation" but "alteration." When the parties to a contract agree for "novation," the original contract is discharged and need not be performed.

ILLUSTRATIONS *(a)* *A* is indebted to *B* and *B* to *C*. By mutual agreement *B*'s debt to *C* and *B*'s loan to *A* are cancelled and *C* accepts *A* as his debtor. There is novation involving change of parties.

(b) *A* owes *B* Rs 10,000. *A* enters into an agreement with *B*, and gives *B* a mortgage of his (*A*'s) estate for Rs 5,000 in place of the debt of Rs 10,000. This is a new contract and extinguishes the old. [Illustration (*b*) to Section 62]

The following points are also worth noting in connection with novation:

(a) Novation cannot be compulsory, it can only be with the mutual consent of all the parties.

ILLUSTRATION. *A* owes *B* Rs 1,000 under a contract. *B* owes *C* Rs 1,000. *B* orders *A* to credit *C* with Rs 1,000 in his books, but *C* does not assent to the agreement. *B* still owes *C* Rs 1,000 and no new contract has been entered into. [Illustration *(c)* to Section 62]

(b) The new contract must be valid and enforceable. If it suffers from any legal flaw *e.g.*, want of proper stamp or registration *etc.*, on account of which it becomes unenforceable, then the original contract revives (*Mahabir Prasad* vs *Satyanarain*[4]).

2. **Alteration.** Alteration of a contract means change in one or more of the material terms of a contract. If a material alteration in a written contract is done by mutual consent, the original contract is discharged by alteration and the new contract in its altered form takes its place. A material alteration is one which alters the legal effect of the contract, *e.g.*, a change in the amount of money to be paid or a change in the rate of interest. Immaterial alteration, *e.g.*, correcting a clerical error in figures or the spelling of a name, has no effect on the validity of the contract and does not amount to alteration in the technical sense.

[4]A.I.R. (1963), Pat. 131.

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It is relevant to state that a material alteration made in a written contract by one party *without the consent* of the other, will, make the *whole* contract void and no person can maintain an action upon it. It comes under "discharge of a contract by operation of law" which will be discussed later.

The difference between "novation" and "alteration" may be noted. In case of novation there may be a change of parties also while in case of alteration parties remain the same, only the terms of a contract are altered.

3. **Rescission.** A contract may be discharged, before the date of performance, by agreement between the parties to the effect that it shall no longer bind them. Such an agreement amounts to "rescission" or cancellation of the contract, the consideration for mutual promises being the abandonment by the respective parties of their rights under the contract. An agreement of rescission releases the parties from their obligations arising out of the contract. Such agreements are to be distinguished from 'agreements in restraint of legal proceedings" which are void as per Section 28. Law cannot force the parties to take a legal action for breach of contract and therefore if they consent to treat non-performance or part performance of a contract equivalent to full performance or discharge of the contract, it is perfectly alright. If is just like this: *A* contracts to marry *B*. It is a valid contract. But if *A* contracts with *B* not to marry *C*, it is a void agreement "being in restraint of marriage" as per Section 26. Hence "an agreement to excuse performance" is valid, while "an agreement not to sue for breach" is void, although in practical life both may mean the same.

ILLUSTRATION. *A* promises to deliver certain goods to *B* on a certain date. Before the date of performance, *A* and *B* mutually agree that the contract will not be performed. The contract stands discharged by rescission.

There may also be an implied rescission of a contract *e.g.*, where there is non-performance of a contract by both the parties for a long period, without complaint, it amounts to an implied rescission.

Notice that in the case of rescission, the existing contract is cancelled by mutual consent without substituting a new contract in its place.

4. **Remission.** Remission may be defined "as the acceptance of a lesser sum than what was contracted for *or* a lesser fulfilment of the promise made."

Section 63 deals with remission of performance and lays down that a promisee may remit or give up wholly or in part, the performance of the promise made to him, and a promise to do so is binding even though there is no consideration for it. The Section further provides that an agreement to extend the time for the performance of a promise also does not require consideration to support it on the ground that it is a partial remission of performance.

ILLUSTRATIONS. *(a)* If the promisee agrees to accept Rs 2,000 in full

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satisfaction of a claim of Rs 5,000, the promise is enforceable and the promisee cannot in future bring a suit for the recovery of Rs 5,000. (In England it would have been only "accord" which is unenforceable and the actual payment of Rs 2,000 and its acceptance in full satisfaction of the claim by the other party would have been "accord and satisfaction" which alone would have discharged the old contract. "Accord" without "satisfaction" is no discharge of the contract in English law.)

(b) A owes *B* Rs 5,000. *A* pays to *B* and *B* accepts, in satisfaction of the whole debt, Rs 2,000 paid at the time and place at which the Rs 5,000 were payable. The whole debt is discharged [Illustration *(b)* to Section 63].

(c) A owes *B* Rs 2,000, and is also indebted to other creditors. *A* makes an agreement with his creditors, including *B*, to pay them a composition of eight annas (fifty paise) in the rupee upon their respective demands. Payment to *B* of Rs 1,000 is a discharge of *B*'s demand [Illustration *(e)* to Section 63].

(d) A owes *B* Rs 5,000 payable on 1st June. *A* is not in a position to meet his liability on the due date and as such makes a request to *B* to extend the time for payment by three months. *B* accedes to *A*'s request. The promise is binding and no suit can be instituted before the expiry of the extended period of credit although the promise is not supported by any consideration.

5. **Waiver.** Waiver means the deliberate abandonment or giving up of a right which a party is entitled to under a contract, whereupon the other party to the contract is released from his obligation. Strictly speaking there is no need of an agreement for a waiver but because we are discussing it as a method of discharge under 'mutual consent,' we presume that the other party consents to it. Thus, where *A* promises to tailor a shirt for *B* if he will sing a song at his birthday party and accordingly *B* sang the song but afterwards *B* forbids *A* to tailor the shirt, to which *A* consents, the contract is terminated by waiver.

Discharge by Subsequent or Supervening Impossibility or Illegality

Impossibility at the time of contract. There is no question of discharge of a contract which is entered into to perform something that is *obviously impossible, e.g.,* an agreement to discover treasure by magic, because, in such a case there is no contract to terminate, it being an agreement void *ab-initio* by virtue of Section 56, Para 1, which provides: "an agreement to do an act impossible in itself is void." Notice that this paragraph of the Section speaks of something which is impossible inherently or by its very nature and which may or may not be known to *both* the parties at the time when the contract is made.

But if the impossibility is *not obvious* and the promisor alone knows of the impossibility or illegality then existing or the promisor might have known as such after using reasonable diligence, such promisor is bound to compensate the promisee for any loss he may suffer through the non-performance of the promise, in spite of the agreement being void *ab-initio* [Section 56, Para 3].

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ILLUSTRATION. *A* contracts to marry *B*, being already married to *C*, and being forbidden by the law to which he is subject to practise polygamy. *A* must make compensation to *B* for the loss caused to her by the non-performance of his promise [Illustration *(c)* to Section 56].

Subsequent impossibility. In fact it is this case, where the impossibility supervenes after the contract has been made, which is material to our study of discharge of contracts. In this connection, Section 56, Para 2, declares: "A contract to do an act which, after the contract is made, becomes impossible, or, by reason of some event which the promisor could not prevent, unlawful, becomes void when the act becomes impossible or unlawful".

In order that the Section would apply the following conditions must be fulfilled: (1) that the act should have become impossible; (2) that impossibility should be by reason of some event which the promisor could not prevent; and (3) that the impossibility should not be self-induced by the promisor or due to his negligence. Further, the word "impossible" should be construed here in its practical sense and not only in a physical or literal sense. It is sufficient for the act to be impossible that it becomes impracticable or extremely hazardous or useless from the point of view of the object and purpose which the parties had in view, because if an untoward event or change of circumstances totally upsets the very foundation upon which the parties rested their bargain, it can very well be said that the promisor found it impossible to do the act which he promised to do.[5]

Thus, under Section 56 (Para 2), where an event which could not reasonably have been in the contemplation of the parties when the contract was made, renders performance impossible or unlawful, the contract becomes void and stands discharged. This is known as frustration of the contract brought about by supervening impossibility. It is also known as the *doctrine of supervening impossibility.* The rationale behind the doctrine is that if the performance of a contract becomes impossible by reason of supervening impossibility or illegality of the act agreed to be done, it is logical to absolve the parties from further performance of it as they never did promise to perform an impossibility.

It seems necessary to emphasise that the "doctrine of supervening impossibility," as enunciated in Section 56 (Para 2), is wider than the "doctrine of frustration" known to the English law. Referring to this aspect, the Supreme Court observed in *Satybrata Ghose* vs *Mugneeram Bangur & Co.*,[6] as follows:

"The doctrine of frustration is really an aspect or part of the law of

[5]Adapted from the Supreme Court observation in *Satyabrata Ghose* vs *Mugneeram Bangur & Co.*, (1954), S.C. 44.

[6]*Ibid.*

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discharge of contract by reason of supervening impossibility or illegality of the act agreed to be done and hence comes within the purview of Section 56 of the Contract Act. It would be incorrect to say that Section 56 applies only to cases of physical impossibility and that where this Section is not applicable, recourse can be had to the principles of English law on the subject of frustration. It must be held also that to the extent that the Contract Act deals with a particular subject, it is exhaustive upon the same and it is not permissible to import the principles of English law *de hors* these statutory provisions."

It is for the reason stated above that we shall not be discussing the "doctrine of frustration of English law" separately.

It may be of interest to note that in the case of subsequent impossibility or illegality, the dissolution of the contract occurs automatically. It does not depend, as does "novation" or "remission" of a contract, on the choice of the parties. It depends on the effect of what has actually happened on the possibility of performing the contract.

Cases where the doctrine of supervening impossibility applies. A contract will be discharged on the ground of supervening impossibility in the following cases:

1. **Destruction of subject-matter.** When the subject-matter of a contract, subsequent to its formation, is destroyed, without the fault of the promisor or promisee, the contract is discharged. Note that it is so only when specific property or goods are destroyed which cannot be regained.

ILLUSTRATIONS. *(a)* A music hall was agreed to be let out for a series of concerts on certain days. The hall was destroyed by fire before the date of the first concert. The plaintiff sued the defendant for damages for the breach of contract. It was held that the contract has become void and the defendant was not liable (*Taylor* vs *Caldwell*[7]).

(b) The defendant contracted to sell a part of a specific crop of potatoes to be grown on his farms, but failed to supply them as the crop was destroyed by a pest. The contract was held to be discharged (*Howell* vs *Coupland*[8]).

(c) Similarly, if a factory premises on which a machinery is to be installed are destroyed by fire, or a ship under a charter party is seized by a foreign government, the contract is discharged (*Tatem Ltd.* vs *Gamboa*[9]).

2. **Failure of ultimate purpose.** Where the ultimate purpose for which the contract was entered into fails, the contract is discharged, although there is no destruction of any property affected by the contract and the performance of the contract remains possible in literal sense. The leading case of

[7](1863), 122 A.R. 299. For an Indian case see: *V.L. Narasu* vs *P.S.V. Iyer*, (1953), I.L.R. Mad. 831.

[8](1876), 1 Q.B.D. 258.

[9](1939), 1 K.B. 132.

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Krell vs *Henry*[10] is a good illustration on the point:

H hired a room in London from *K* with the object; as both parties well knew; of using the room to view the intended coronation procession of King Edward VII on a particular date. By reason of the King's illness the procession was postponed. *H* consequently could not use the room although he could go there and sit but with no purpose as there was no procession. *K* filed a suit for the recovery of rent. It was held that *H* need not pay the rent as the contract was discharged on failure of the ultimate purpose or on postponement of the procession which was the foundation of the contract.

3. **Death or personal incapacity of promisor.** Where the performance of a contract depends upon the personal skill or qualification or the existence of a given person, the contract is discharged on the illness or incapacity or the death of that person.

ILLUSTRATIONS. *(a) A* and *B* contract to marry each other. Before the time fixed for the marriage, *A* goes mad. The contract becomes void [Illustration *(b)* to Section 56].

(b) A contracts to act at a theatre for six months in consideration of a sum paid in advance by *B*. On several occasions *A* is too ill to act. The contract to act on those occasions becomes void [Illustration *(e)* to Section 56].

(c) An artist undertook to paint a picture for a certain price, but before he could do so, he met with an accident and lost his right arm. Held, the artist was discharged due to disablement.

4. **Change of law.** A subsequent change in law may render the contract illegal and in such cases the contract is deemed discharged. The law may actually forbid the doing of some act undertaken in the contract, or it may take from the control of the promisor something in respect of which he has contracted to act or not to act in a certain way.

ILLUSTRATIONS. *(a) A* sold to *B* 100 bags of wheat at Rs 700 per bag. But before delivery the Government rendered the sale and purchase of wheat by private traders illegal under the Defence of India Rules. The contract was discharged by impossibility created by subsequent change in law.

(b) There was a contract for the sale of the trees of a forest. Subsequently by an Act of Legislature, the forest was acquired by the State Government. The contract was discharged because it had become impossible of performance.

5. **Outbreak of war.** All contracts entered into with an alien enemy *during war* are illegal and void *ab-initio*. Contracts entered into *before* the outbreak of war are suspended during the war and may be revived after the war is over provided they have not already become time-barred. It may be noted that if war is declared between the countries of the contracting parties then only the contract is suspended during war. If war is declared between the country of one of the parties to the contract and a third country, the

[10](1903), 2 K.B. 740. For an Indian case see: *Jawala Pd.* vs *Jawala Bank*, A.I.R. (1957), All. 143.

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contract remains binding, and if the party of the country now at war could not perform the contract because of dislocation of transport *etc.*, it will be treated as "difficulty in performance" only and does not discharge the contract *(Tsakiroglou & Co., Ltd.* vs *Noblee Thorl*[11]).

Cases not Covered by Supervening Impossibility

"He that agrees to do an act must do it or pay damages for not doing it" is the general rule of the law of contract. Thus, unless the performance becomes absolutely impossible (as discussed above), a person is bound to perform any obligation which he has undertaken, and cannot claim to be excused by the mere fact that performance has subsequently become unexpectedly burdensome, more difficult or expensive. Some of the cases where impossibility of performance is not an excuse are as follows:

1. **Difficulty of performance.** Increased or unexpected difficulty and expense do not, as a rule, excuse from performance.

ILLUSTRATIONS. *(a) A*, sold to *B* a certain quantity of Finnish birch timber. *A*, found it impossible to fulfil this contract because the outbreak of war disorganised the transport and *A* could not get any supply of timber from Finland. Held, *B* was not concerned with the way in which *A* was going to get timber and therefore there was no frustration. The Court of Appeal observed: "For the contract to be dissolved there must have been a failure of something which was at the basis of the contract in the intention of *both* parties, and that was not the case here." (*Blackburn Bobbin Co., Ltd.* vs *Allen & Sons Ltd.*[12])

(b) X contracted with *Y* to send certain goods from Bombay to Delhi in September. In August transport companies went on strike and transport was available at very high rates. Held, the increase in freight rates did not excuse performance (*Karl Etlinger* vs *Chagandas & Co.*[13]).

2. **Commercial impossibility.** When in a transaction profits dwindle to a very low level or actual loss becomes certain, it is said that the performance of the contract has become commercially impossible. Such a situation may arise on account of higher price of the raw material or increase in the wage bill *etc.* Commercial impossibility also does not discharge a contract (*Sachindra* vs *Gopal*[14]).

3. **Impossibility due to the default of a third person.** The doctrine of supervening impossibility does not cover cases where the contract could not be performed because of the impossibility created by the failure of a third person on whose work the promisor relied.

ILLUSTRATIONS. *(a) A*, a wholesaler, enters into a contract with *B* for the sale of certain goods 'to be produced by *Z*', a manufacturer of those goods. *Z* does

[11](1962), A.C. 93.
[12](1918), 2 K.B. 467.
[13](1916), 40 Bom. 301.
[14](1949), Cal. 240.

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not manufacture those goods. *A* is liable to *B* for damages. The words 'to be produced by *Z*' simply indicate quality of goods here.

(b) A, agreed to sell to *B* 61 bales of cloth to be manufactured by the New Victoria Mills, Kanpur, "as soon as they are supplied to him by the said Mill." In a suit for damages for non-delivery of goods the defendant *(A)* pleaded impossibility on the ground that the goods were not supplied to him by the Mill. Held, that the words "as soon as they are supplied to him by the Mill" simply indicate *the process of delivery* and did not convey the meaning that delivery was contingent on their being supplied by the Mill. Hence the case did not fall within the provisions of Sections 32 and 56 as the default was due to the fault of the defendant. *B* is, therefore, entitled to recover damages from *A*. (*Ganga Saran* vs *Ram Charan Ram Gopal*[15])

4. **Strikes and lock-outs.** A strike by the workmen or a lock-out by the employer also does not excuse performance because the former is *manageable* (as labour is available otherwise) and the latter is *self-induced.* Where the impossibility is not absolute or where it is due to the default of the promisor himself, Section 56 would not apply. As such these events also do not discharge a contract.

ILLUSTRATION. The lessor of certain salt pans, failed to repair them according to the terms of the contract, on the ground of a strike of the workmen. Held, a strike by the workmen was not sufficient reason to excuse performance of a term of the contract (*Hari Laxman* vs *Secretary of State for India*[16]).

5. **Failure of one of the objects.** When a contract is entered into for several objects, the failure of one of them does not discharge the contract.

ILLUSTRATION. A company agreed to let out a boat to *H, (a)* for viewing a naval review on the occasion of the coronation of King Edward VII, and *(b)* to sail round the fleet. Due to illness of the King, the naval review was later cancelled but the fleet was assembled. Held, the contract was not discharged because the holding of the review was not the sole basis of the contract. To sail round the fleet, which formed an equally basic object of the contract was still capable of attainment (*H.B. Steamboat Co.* vs *Hutton*[17]).

Discharge by Lapse of Time

The Limitation Act lays down that in case of breach of a contract legal action should be taken within a specified period, called the period of limitation, otherwise the promisee is debarred from instituting a suit in a court of law and the contract stands discharged. Thus in certain circumstances lapse of time may also discharge a contract. For example, the period of limitation for simple contracts is three years under the Limitation Act, and therefore on default by a debtor if the creditor does not file a suit of

[15](1952), S.C.R. 36.
[16](1928), 30 Bom. L.R. 49.
[17](1903), 2 K.B. 683.

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recovery against him within three years of default, the debt becomes time-barred on the expiry of three years and the creditor will be deprived of his remedy at law. This in effect implies discharge of contract.

Again, where "time is of essence in a contract," if the contract is not performed at the fixed time, the contract comes to an end, and the party not at fault need not perform his obligation and may sue the other party for damages.

Discharge by Operation of Law

A contract terminates by operation of law in the following cases:

(a) **Death.** Where the contract is of a personal nature, the death of the promisor discharges the contract. In other contracts the rights and liabilities of the deceased person pass on to the legal representatives of the dead man.

(b) **Insolvency.** A contract is discharged by the insolvency of one of the parties to it when an Insolvency Court passes an "order of discharge" exonerating the insolvent from liabilities on debts incurred prior to his adjudication.

(c) **Merger.** Where an inferior right contract merges into a superior right contract, the former stands discharged automatically.

ILLUSTRATIONS. *(a)* Where a man holding property under a contract of tenancy buys the property, his rights as a tenant are merged into the rights of ownership and the contract of tenancy stands discharged by operation of law.

(b) Where a part-time lecturer is made full time lecturer, the contract of part-time lecturership is discharged by merger.

(c) A bill of exchange is discharged if the acceptor becomes the holder of it at or after its maturity in his own right.

(d) **Unauthorised material alteration.** A material alteration made in a written document or contract by one party without the consent of the other, will make the whole contract void. Thus, where the amount of money to be received is altered, or an additional signature is forged, on a promissory note by a creditor, he cannot bring a suit on it and the pro-note cannot be enforced against the debtor even in its original shape. The effect of making such an alteration is exactly the same as that of cancelling the contract (*Gour Chunder* vs *Prasanna*[18]). However, the document, though altered, can be used as proof of the transaction and the creditor may be allowed to claim refund of money actually advanced by him under Section 65 of the Contract Act which is based on the equitable doctrine of restitution (*Ananthrao* vs *Kandikanda*[19]).

Dischange by Breach of Contract

Breach of contract by a party thereto is also a method of discharge of

[18](1906), 33 Cal. 812.
[19](1920), 43 Mad. 703.

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a contract, because "breach" also brings to an end the obligations created by a contract on the part of each of the parties. Of course the aggrieved party *i.e.*, the party not at fault can sue for damages for breach of contract as per law; but the contact as such stands terminated.

Breach of contract may be of two kinds: (1) Anticipatory breach; and (2) Actual breach.

1. **Anticipatory breach.** An anticipatory breach of contract is a breach of contract occurring before the time fixed for performance has arrived. It may take place in two ways:

(a) Expressly by words spoken or written. Here a party to the contract communicates to the other party, before the due date of performance, his intention not to perform it. For example, *A* contracts with *B* to supply 100 bags of wheat for Rs 60,000 on 1st March. On 15th February *A* inform *B* that he will not be able to supply the wheat. There is express rejection of the contract.

(b) Impliedly by the conduct of one of the parties. Here a party by his own voluntary act disables himself from performing the contract. For example, *(i)* a person contracts to sell a particular horse to another on 1st of June and before that date he sells the horse to somebody else; *(ii) A* agrees to marry *B* but before the agreed date of marriage she marries *C*. In both the above cases there occurs an anticipatory breach of contract brought about by the conduct of one of the parties.

Section 39 of the Contract Act deals with anticipatory breach of contract and provides as follows: "When a party to a contract has refused to perform, or disabled himself from performing, his promise in its entirety, the promisee may put an end to the contract, unless he has signified, by words or conduct, his acquiescence in its continuance."

Effect of an anticipatory breach. When there is an anticipatory breach of contract, the promisee is excused from performance or from further performance. Further, it gives an option[20] to the promisee *(i.e.,* the aggrieved party) whereby:

(i) he may either treat the contract as rescinded and sue the other party for damages for breach of contract immediately without waiting until the due date of performance, or

(ii) he may elect not to rescind but to treat the contract as still operative, and wait for the time of performance and then hold the other party responsible for the consequences of non-performance. But in that case, he will keep the contract alive for the benefit of the other party as well as his own, and the guilty party, if he so decides on reconsideration, may still

[20]*Frost* vs *Knight,* (1897), 21 Bom 23.

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perform his part of the contract and can also take advantage of any supervening impossibility which may have the effect of discharging the contract.

ILLUSTRATIONS. *(a) A*, agrees to employ *B* as a clerk, the service to commence from 1st June. On the 20th of May he informs *B* that his services will not be required. *B* is exonerated from his obligation under the contract and may at once sue *A* for damages for breach of contract without waiting until the time fixed for performance (*Mersey Steel and Iron Co.* vs *Naylor*[21]).

(b) A, agrees to sell his house to *B* for Rs 8,50,000 on 1st of March. But on 10th February he changes his mind and writes to *B* that he will not be able to sell his house. There is an anticipatory breach of contract. Two courses are open to *B*: (*i*) he may treat the contract as rescinded and at once sue *A* for damages, or (*ii*) he may wait till 1st of March. *B* adopts the second course. On 28th February the house is destroyed by fire. The contract stands discharged by supervening impossibility. *A* is entitled to take advantage of this supervening impossibility and *B* cannot recover any damages from him. If the house did not catch fire, *A* could have taken back his letter of repudiation and asked *B* to take possession of the house on payment as per agreement.

2. **Actual breach.** Actual breach may also discharge a contract. It occurs when a party fails to perform his obligation upon the date fixed for performance by the contract, as for example, where on the appointed day the seller does not deliver the goods or the buyer refuses to accept the delivery. It is important to note that there can be no actual breach of contract by reason of non-peformance so long as the time for performance has not yet arrived. Actual breach entitles the party not in default to elect to treat the contract as discharged and to sue the party at fault for damages for breach of contract.

TEST QUESTIONS

1. State briefly the various modes in which a contract may be discharged.
2. What do you mean by "attempted performance or tender?" State the essentials of a vital tender. Discuss the effect of refusal to accept a valid tender.
3. Discuss the law relating to discharge of a contract by mutual consent.
4. What is meant by "supervening impossibility?" Does this excuse the promisor from performing the contract in all cases?
5. "Impossibility of performance is, as a rule, not an excuse for non-performance of a contract." Discuss.
6. Discuss fully the "doctrine of supervening impossibility."
7. What do you understand by "anticipatory breach of contract?" Discuss the consequences of such breach on the rights and liabilities of the parties.

[21](1884), 9 App. Cas 434.

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PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. The unloading of a ship was delayed beyond the date agreed with the shipowners owing to a strike of dock labourers. On a suit by the shipowners for damages, the plea of impossibility of performance was raised. Advise the shipowners.

[Hint. The shipowners are bound to succeed in the suit. Strike by workmen renders performance only difficult or expensive and not impossible and as such it is not covered under the doctrine of supervening impossibility.]

2. *A* contracts to marry *B* in two years time. Shortly afterwards he breaks off the engagement without *B's* consent. *B* writes repeatedly begging him to adhere to the contract. Just before the expiry of two years, a change in law makes it illegal for *A* to marry *B*. On the expiry of two years, *B* sues *A* for the breach of the contract. Will she succeed?

[Hint. No, *B* will not succeed because when she files the suit for breach, the contract has already been discharged by supervening impossibility and *A* is entitled to take advantage of that. (Refer to "Anticipatory Breach")]

3. A wine merchant contract to sell to a customer five dozen bottles of a particular brand of Champagne. At the time of the contract the wine merchant's whole stock of wine had been destroyed by fire, but he was not aware of this fact. What is the effect on the legal rights of the parties?

[Hint. The legal rights of the parties remain unaffected. It is only the destruction of specific subject-matter which cannot be replaced, that the contract is discharged under impossibility. As it is not so here and the bottles can be procured from somewhere else, the wine merchant is bound to supply.]

4. *A* agrees to sell his scooter to *B* a month after the date of the contract. But just after 10 days of the contract he sells the scooter to *C.* Thereupon *B* sues *A* for the breach of contract. *A* contends that he could still perform the contract by repurchasing the scooter from *C*. Decide the suit.

[Hint. Here there is anticipatory breach of contract by conduct from *A's* side and therefore his contention will not be upheld. *B* is entitled to elect to treat the contract as rescinded and sue *A* for the breach of contract immediately.]

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Chapter 11

Quasi-Contracts

We have seen that a contract is the result of an *agreement* enforceable by law. But in some cases there is no offer, no acceptance, no consensus *ad-idem* and in fact no intention on the part of parties to enter into a contract and still the law, from the conduct and relationship of the parties, implies a promise imposing obligation on the one party and conferring a right in favour of the other. In other words under certain special circumstances obligations resembling those created by a contract are imposed by law although the parties have never entered into a contract. Such obligations imposed by law are referred to as 'Quasi-Contracts' or 'Constructive Contracts' under the English law, and "certain relations resembling those created by contracts" under the Indian law. The term ' quasi-contract' has been used because such a contract resembles with a contract so far as result or effect is concerned but it has little or no affinity with a contract in respect of mode of creation.

A quasi-contract rests upon the equitable "doctrine of unjust enrichment" which declares that a person shall not be allowed to enrich himself unjustly at the expense of another. Duty, and not a promise or agreement, is the basis of such contracts. It may be noted that a suit for damages for the breach of the contract can be filed in the case of a quasi-contract in the same way as in the case of a completed contract (Sec. 73).

The Contract Act deals with 'quasi-contractual obligations' under Sections 68 to 72, which are discussed below:

1. **Claim for necessaries supplied to a person incapable of contracting or on his account** (Sec. 68). "If a person, incapable of entering into a contract, or any one whom he is legally bound to support, is supplied by another person with necessaries suited to his condition in life, the person who has furnished such supplies is entitled to be reimbursed from the property of such incapable person."

This provision has already been considered in connection with *minor's agreements* in the chapter of "Capacity of Parties." With a view to recapitulate it may be stated here that although agreements by minors, idiots, lunatics, etc., are void *ab-initio*, but Section 68 makes an exception to this rule by providing that their estates are liable to reimburse the supplier who

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supplies them or to some one whom they are legally bound to support with 'necessaries' of life. The following points need to be emphasised:

(i) The Section does not create any personal liability but only the estates are liable.

(ii) The things supplied must come within the category of 'necessaries'. The word 'necessaries' here covers not only bare necessities of existence, *e.g.,* food and clothes, but all things which are reasonably necessary to the incompetent person, having regard to his status in society, *e.g.,* a watch, a radio, a bicycle may be included therein.

(iii) Necessaries should be supplied only to such incompetent person or to some one whom he is legally bound to support, such as his wife and children.

(iv) Incompetent person's property is liable to pay only a reasonable price for the goods or services supplied and not the price which the incompetent person might have 'agreed to' (legally speaking an incompetent person cannot agree to anything).

ILLUSTRATIONS (to Sec 68). *(a) A* supplies *B*, a lunatic, with necessaries suitable to his condition in life. *A* is entitled to be reimbursed from *B*'s property.

(b) A supplies the wife and children of *B*, a lunatic, with necessaries suitable to their condition in life. *A* is entitled to be reimbursed from *B*'s property.

2. **Reimbursement of person paying money due by another, in payment of which he is interested** (Sec. 69). "A person who is interested in the payment of money which another is bound by law to pay, and who therefore pays it, is entitled to be reimbursed by the other."

ILLUSTRATION (to Sec. 69). *B* holds land in Bengal, on a lease granted by *A*, the zamindar. The revenue payable by *A* to the Government being in arrear, his land is advertised for sale by the Government. Under the revenue law, the consequence of such sale will be the annulment of *B*'s lease. *B*, to prevent the sale and the consequent annulment of his own lease, pays to the government the sum due from *A*. *A* is bound to make good to *B* the amount so paid.

In order to make Section 69 applicable, the following conditions must be satisfied:

(i) The plaintiff should be interested in making the payment in order to protect his own interest and the payment should not be voluntary one. Moreover, the payment must have been done in good faith and not to manufacture evidence of title to land or any other thing.

ILLUSTRATIONS. *(a)* A sub-tenant pays the arrears of rent due by the tenant to the landlord, in order to save the tenancy from forfeiture. The sub-tenant is entitled to recover from the tenant, the amount paid by him to the landlord, although there is no contract between the two.

(b) A, pays the arrears of rent of his neighbour *B*, just to avoid a struggle between *B* and his landlord. *A* cannot recover from *B* as he acted voluntarily and had no interest of his own in the payment. [But if *B* should agree to reimburse *A*, this would be a good contract under Section 25(2).]

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(ii) The payment must be such as the other party was bound by law to pay.

ILLUSTRATION. *A*'s goods were wrongfully attached to realise the arrears of Government revenue due by *B*. *A* pays the dues to save the goods from being sold. He is entitled to recover the amount from *B* (*Abid Hussain* vs *Ganga Sahai*[1]).

(iii) The payment must *not* be such as the plaintiff himself was *bound* to pay. He should only be interested in making the payment. In other words, a suit under this Section is maintainable only for reimbursement and not for contribution. Thus, where there is a joint liability on joint wrong doers and only one of them discharges the liability, no suit for contribution from the other would be maintainable under this Section (*Ramkrishna* vs *Radhakrishana*[2]). [A suit for contribution from the other joint promisor would be maintainable under Section 43.]

ILLUSTRATION. *A* and *B* have been fined jointly Rs 500 for selling adulterated ghee. *A* alone pays the amount of fine in good faith. *A* cannot later claim contribution from *B* under Section 69. Notice that although *B* was bound by law to pay and *A* has paid *B's* share in good faith, yet *A* cannot recover as he himself was *bound* to make the payment, being jointly liable with *B* and was not simply interested in making the payment. [*A* can, however, claim contribution from *B* under Section 43.]

3. **Obligation of person enjoying benefit of non-gratuitous act** (Sec. 70). This is the third type of quasi-contract provided in the Contract Act. Section 70 lays down thus, "Where a person lawfully does anything for another person, or delivers anything to him, not intending to do so gratuitously, and such other person enjoys the benefit thereof, the latter is bound to make compensation to the former in respect of, or to restore, the thing so done or delivered."

For giving rise to a right of action under this Section, the following three conditions must be fulfilled:

(i) The thing must have been done lawfully in goods faith. This means that the act done must be in pursuance of the implied wishes (because there should not be any request in the case of a quasi-contract) and in the presence of the other party, giving him the full choice to reject the thing or service.

(ii) The thing must have been done by a person not intending to act gratuitously, *i.e.*, it must have been done with the intention of being paid for.

(iii) The person for whom the act is done must have enjoyed the benefit of the act.

[1](1928), 26 All. L.J. 435.
[2]A.I.R. (1970), Ori. 237.

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ILLUSTRATIONS. *(a) A*, a tradesman, leaves goods at *B*'s house by mistake *B* treats the goods as his own. He is bound to pay *A* for them. [Illustration to Section 70]

(b) A saves *B*'s property from fire. *A* is not entitled to compensation from *B* if the circumstances show that he intended to act gratuitously. [Illustration to Section 70]

(c) Where a coolie takes the luggage at the railway station without being asked by the passenger *or* a shoe-shiner starts shining shoes of the passenger without being asked to do so, and if the passenger does not object to that, then he is bound to pay reasonably for the same as the work was not intended to be gratuitous.

4. **Responsibility of finder of goods** (Sec. 71). Section 71 lays down another circumstance in which also a quasi-contractual obligation is to be presumed. It says: "A person who finds goods belonging to another and takes them into his custody, is subject to the same responsibility as a bailee." Thus an agreement is also implied by law between the owner and finder of the goods and the latter is deemed to be a bailee.[3]

The liabilities and rights of a finder of goods have been discussed in Sections 168—169 which provide as follows:

Liabilities of finder of goods. He must try to find out the real owner of the goods and must not appropriate the property to his own use. If the real owner is traced, he must restore the goods to him on demand. If he does not take these measures, he will be guilty of criminal mis-appropriation of the property under Section 403 of Indian Penal Code. Further, till the goods are in possession of the finder, he must take as much care of the goods as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quality and value (Sec. 151).

Rights of finder of goods.[4] Till the true owner is found out, he can retain possession of the goods against everybody in the world. He is entitled to receive from the true owner, all expenses incurred by him for preserving the goods or finding the true owner. He has a lien on the goods for the money so spent *i.e.,* he can refuse to return the goods to the true owner until these moneys are paid. He is not entitled to file a suit for the recovery of such sums. But he can file a suit against the owner to recover any reward, which was offered by the owner for the return of the goods, provided he came to know of the offer of reward before actually finding out the goods.

The finder of goods is entitled to sell the goods if the owner cannot be found out *or* if he refuses to pay the lawful charges of the finder, in the following two situations only:

(a) when the thing is in danger of perishing or of losing the greater part of its value, or

[3]For the duties and rights of a bailee, refer to Chapter 14—*Bailment and Pledge.*
[4]These have been discussed in detail in Chapter 14.

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(b) when the lawful charges of the finder amount to two-thirds of the value of the goods found.

The true owner is entitled to get the balance of sale proceeds, if there is surplus after meeting the lawful charges.

It is to be noted that no one except the real owner can claim possession of goods from the finder. If anybody deprives him of the possession of the goods, he can file a suit for damages for trespass.

ILLUSTRATION. *H* picked up a diamond on the floor of *F*'s shop and handed it over to *F* to keep it till the owner appeared. In spite of best efforts the true owner could not be searched. After the lapse of some weeks, *H* tendered to *F* the lawful expenses incurred by him for finding the true owner and an indemnity bond and requested him to return the diamond to him (*i.e., H*). *F* refused to do so. Held, *F* must return the diamond to *H* as he was entitled to retain the goods as against everybody except the true owner (*Hollins* vs *Fowler*[5]).

5. **Liability of person to whom money is paid, or thing delivered by mistake or under coercion** (Sec. 72). This is the fifth and the last kind of quasi-contract mentioned in the Act. Section 72 declares thus, "A person to whom money has been paid, or anything delivered, by mistake or under coercion, must repay or return it." Accordingly, if one party under a mistake pays to another party money which is not due by contract or otherwise, that money must be repaid.

The term 'mistake' has been used in the Section without any qualification or limitation whatever and comprises within its scope a mistake of law as well as a mistake of fact (*Sales Tax Officer* vs *Kanhaiyalal Mukundlal*[6]). The term 'coercion' has been used in its ordinary sense and not as defined in Section 15[7] (*Peplad Bulakhidas Mills* vs *Union of India*[8]). Here 'coercion' means 'under pressure'.

ILLUSTRATIONS. *(a) A* and *B* jointly owe Rs 100 to *C*. *A* alone pays the amount to *C*, and *B*, not knowing this fact, pays Rs 100 over again to *C*. *C* is bound to repay the amount to *B* [Illustration to Section 72].

(b) A railway company refuses to deliver up certain goods to the consignee, except upon the payment of an illegal charge for carriage. The consignee pays the sum charged in order to obtain the goods. He is entitled to recover so much of the charge as was illegally excessive (Illustration to Section 72).

(c) A pays some money to *B* by mistake. It is really due to *C*. *B* must refund the money to *A*. *C*, however, cannot recover the amount from *B* in the absence of privity of contract between *B* and *C*.

(d) A fruit parcel is delivered under a mistake to *R* who consumes the fruits thinking them as birthday present. *R* must return the parcel or pay for the fruits.

[5]L.R. 7 H.L. 757.

[6](1959), S.C.R. 1350.

[7]For the definition of 'coercion' as given in Sec. 15, refer to Chapter 5—*Free Consent*.

[8]A.I.R. (1970), Guj. 59.

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Although there is no agreement between *R* and the true owner, yet he is bound to pay as the law regards it a quasi-contract.

It is to be noted that this Section does not cover a case where money has been paid in payment of a natural obligation. Thus, where one has paid up a time-barred debt, he cannot recover it. Similarly, the Section does not apply when there is a deliberate disregard of law *e.g.*, where moneys are paid voluntarily knowing fully well that the contract has become void, it cannot be recovered under the Section (*Ananth Bandhu* vs *Dom. of India*[9]).

TEST QUESTIONS

1. What are quasi-contracts? Discuss the quasi-contracts dealt with under the Indian Contract Act.

2. "A quasi-contract is not a contract at all. It is an obligation which the law creates." Amplify and state the quasi-contracts recognised under the Indian Contract Act.

3. Under the Indian Contract Act, there are "certain relations resembling those created by a contract." Explain giving illustrations.

4. Discuss the rights and liabilities of a finder of goods.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A,* a Hindu minor, fraudulently representing himself as major, takes a loan of Rs 5,000 for the marriage of his sister from *B* at 8 per cent interest. Can *B* recover the loan and the interest?

[**Hint**. Although the minor cannot be estopped from setting up his minority, yet *B* can recover the loan out of *A*'s property, if any, because marriage expenses of one's sister are included within the scope of 'necessaries' (*Nanadan Pd.* vs *Ajudhia Pd.* 1910, 32 All. 325). Interest, of course, will not be allowed.]

2. *A* contracts to sell a part of a specific crop of potatoes to be grown on his farms to *B* for Rs 1,000. The delivery is to be made after two months and the payment is to be made one month before delivery. Soon after the crop is destroyed by a pest *to the knowledge of both the parties* but still *B* makes the payment as agreed. On the expiry of two months, when no potatoes are delivered to *B, B* sues *A* for breach of the contract and for refund of the purchase price. Will *B* succeed?

[**Hint**. No, *B* will not succeed. The contract in question stands discharged by subsequent destruction of subject-matter and hence there arises no question of its breach. As regards the refund of purchase price, it also cannot be recovered because Sec. 72 does not apply when there is a deliberate disregard of law (*Ananth Bandhu* vs *Dom. of India,* A.I.R. 1955, Cal, 626).]

[9]A.I.R. (1955) Cal. 626.

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Chapter 12

Remedies for Breach of Contract

Whenever there is breach of a contract, the injured party becomes entitled to any one or more of the following remedies against the guilty party:

1. Rescission of the contract.
2. Suit for damages.
3. Suit upon quantum meruit.
4. Suit for specific performance of the contract.
5. Suit for an injunction.

As regards the last two remedies stated above, the law is regulated by the Specific Relief Act, 1963.

Rescission of the Contract

When there is a breach of contract by one party, the other party may rescind the contract and need not perform his part of obligations under the contract and may sit quietly at home if he decides not to take any legal action against the guilty party. But in case the aggrieved party intends to sue the guilty party for damages for breach of contract, he has to file a suit for rescission of the contract. When the court grants rescission, the aggrieved party is freed from all his obligations under the contract; and becomes entitled to compensation for any damage which he has sustained through the nonfulfilment of the contract (Sec. 75).

ILLUSTRATION. *A* contracts to supply 100 kg of tea leaves for Rs 8,000 to *B* on 15 April. If *A* does not supply the tea leaves on the appointed day, *B* need not pay the price. *B* may treat the contract as rescinded and may sit quietly at home. *B* may also file a 'suit for rescission' and claim damages.

Thus, applying to the court for 'rescission of the contract' is necessary for claiming damages for breach or for availing any other remedy. In practice a 'suit for rescission' is accompanied by a 'suit for damages,' *etc.*, in the same plaint.

It is worth noting that in certain cases a suit for 'rescission of the contract' may be filed even when no damages are to be claimed, for example, in case of pledge of movable goods, say gold ornaments, if the

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pledger does not pay as per agreement, the pledgee may[1] file a suit for rescission of the contract (of course within the period of limitation which is 30 years in this case), in order to free himself from his obligation to return the ornaments on payment and to become entitled to sell the ornaments in order to realise his debt.

Suit for Damages

Damages are a monetary compensation allowed to the injured party for the loss or injury suffered by him as a result of the breach of contract. The fundamental principle underlying damages is not punishment but compensation. By awarding damages the court aims to put the injured party into the position in which he would have been, had there been performance and not breach, and not to punish the defaulter party. As a general rule, "compensation must be commensurate with the injury or loss sustained, arising naturally from the breach." "If actual loss is not proved, no damages will be awarded."

Assessment of damages. We will now consider the extent to which a plaintiff is entitled to demand damages for breach of contract. The rules in this regard have been laid down by Section 73. Accordingly, an injured party is entitled to receive from the defaulter party:

(a) Such damages which naturally arose in the usual course of things from such breach. No compensation is to be given generally for any remote or indirect loss sustained by reason of the breach (Ordinary Damages).

(b) Such damages which the parties knew, when they entered into the contract, as likely to result from the breach (Special Damages).

(c) In estimating the loss or damage caused to a party by breach, the means which existed of remedying the inconvenience caused by the breach must also be taken into account (Explanation to Sec. 73). (Duty to mitigate damage suffered.)

With a view to making the study of the quantum of damages easily comprehensible, the above rules, as enunciated in Section 73 may now be considered in some more details under appropriate heads.

Different kinds of damages. Damages may be of four kinds:

1. Ordinary or General or Compensatory damages (*i.e.*, damages arising naturally from the breach).
2. Special damages (*i.e.*, damages in contemplation of the parties at the time of contract).
3. Exemplary, Punitive or Vindictive damages.
4. Nominal damages.

We shall now see these kinds one by one.

[1]The pledgee may also himself sell the goods pledged after giving reasonable notice to the pledger.

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1. Ordinary Damages

When a contract has been broken, the injured party can, as a rule, always recover from the guilty party ordinary or general damages. These are such damages as may fairly and reasonably be considered *as arising naturally and directly in the usual course of things* from the breach of contract itself. In other words, ordinary damages are restricted to the "direct or proximate consequences" of the breach of contract and remote or indirect losses, which are not the natural and probable consequence of the breach of contract, are generally not regarded.

ILLUSTRATIONS. *(a)* The leading case of *Hadley* vs *Baxendale,*[2] which is said to be the foundation of modern law of damages in England and India (as Sec. 73 is almost based on the rules laid down in this case); is an authority on the point. In that case:

H's mill was stopped by a breakage of the crankshaft. *H* delivered the shaft to *B*, a common carrier, to take it to the manufacturers at Greenwich as a pattern for a new one. The only information given to *B* was that the article to be carried was the broken shaft of the mill. It was not made known to *B* that delay would result in loss of profits. By some neglect on the part of *B* the delivery of the shaft was delayed beyond a reasonable time. In consequence the mill remained idle for a longer period than should have been necessary. *H* brought an action against *B* claiming damages for loss of profits which would have been made during the period of delay. *Held* that *B* was not liable for loss of profits caused by the delay because it was a remote consequence, and only nominal damages were awarded. The Court pointed out that *B*, the defendant, was never told that the delay in the delivery of the shaft would entail loss of profits of the mill; the plaintiffs might have had another shaft, or there might have been some other defect in the machinery to cause the stoppage, or for any other reason there might have been loss actually. Accordingly it was not a direct consequence of the breach and hence not recoverable.

(b) A contracts to pay a sum of money to *B* on a specified day. *A* does not pay the money on that day. *B* , in consequence of not receiving the money on that day, is unable to pay his debts, and is totally ruined. *A* is not liable to make good to *B* anything except the principal sum he contracted to pay, together with interest upto the date of payment [Illustration (*n*) to Section 73]. (If a suit has been filed then *A* will have also to pay 'cost of the suit' to *B* .)

(c) A contracts to sell and deliver 500 bales of cotton to *B* on a fixed day. *A* knows nothing of *B*'s mode of conducting his business. *A* breaks his promise, and *B*, having no cotton, is obliged to close his mill. *A* is not responsible to *B* for the loss caused to *B* by the closing of the mill [Illustration (p) to Section 73]. (*B*, however, can claim damages for the breach of contract. He cannot claim the loss of profits caused by the closing of the mill because it cannot be considered to have been in contemplation of both the parties when they made the contract and thus is a remote consequence of the breach.)

In the case of a contract for 'sale and purchase' the general rule as

[2](1854), 9 Exch. 341

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regards measure of damages is that *the damages would be assessed on the difference between the contract price and the market price at the date of breach* and any subsequent increase or decrease in the market price would not be taken note of. If there is no market price for the subject-matter of the contract, the rule is to take the market price of the nearest substitute. If there is no nearest substitute, the market price is to be ascertained by adding to the price at the place of purchase, the conveyance charges to the place of delivery plus the usual profit of the importer (*Hajee Ismail & Sons* vs *Wilson & Co.*[3]). If the delivery is to be made in instalments, then the due date of each instalment is taken as the date of breach and the measure of damages is the sum of the difference of the market value at the several dates of delivery.

ILLUSTRATIONS. *(a) A* agrees to sell to *B* 5 bags of rice at Rs 500 per bag, delivery to be given after two months. On the date of delivery the price of rice goes up and the rate is Rs 550 per bag. *A* refuses to deliver the bags to *B*. *B* can claim from *A* Rs 250, as ordinary damages arising directly from the breach, being the difference between the contract price (*i.e.*, Rs 500 per bag) and the market price (*i.e.*, Rs 550 per bag) on the date of delivery of 5 bags. Notice that if Rs 250 are paid to *B* by way of damages, then he will be in the same position as if the contract has been performed.

(b) A contracts to buy from *B*, at a stated price, 50 maunds of rice, no time being fixed for delivery. *A* afterwards informs *B* that he will not accept the rice if tendered to him. *B* is entitled to receive from *A*, by way of compensation, the amount, if any, by which the contract price exceeds that which *B* can obtain for the rice at the time when *A* informs *B* that he will not accept it [Illustration (*c*) to Section 73].

(c) A contracts to buy *B's* ship for Rs 60,000, but breaks his promise. As a consequence of breach *B* sold the ship in the open market and he could only get Rs 52,000 for the ship. *B* can recover by way of compensation Rs 8,000, the excess of the contract price over the actual sale price [Adapted from Illustration (*d*) to Section 73].

Under a contract of 'sale of goods,' if there is a breach of 'warranty,' the seller is liable to pay all damages which the purchaser has to pay to the person to whom the goods are sold by him, whether the seller is aware of such a sale or not. In order that the purchaser should be able to claim such damages and costs it is an overriding requirement that the sub-contracts should have been made on the same terms and conditions as the first contract.

ILLUSTRATION. [*(m)* to Sec. 73]. *A* sells certain merchandise to *B*, warranting it to be of a particular quality, and *B*, in reliance upon this warranty, sells it to *C* with a similar warranty. The goods prove to be not according to the warranty, and *B* becomes liable to pay *C* a sum of money by way of compensation. *B* is entitled to be reimbursed this sum by *A*..

[3](1918), 41 Mad. 709

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2. **Special Damages**

Special damages are those which arise on account of the special or unusual circumstances affecting the plaintiff. In other words, they are such remote losses which are not the natural and probable consequence of the breach of contract. Unlike ordinary damages, special damages cannot be claimed as a matter of right. These can be claimed only if the special circumstances which would result in a special loss in case of breach of contract are brought to the notice of the other party. It is important that such damages must be in contemplation of the parties at the time when the contract is entered into. Subsequent knowledge of the special circumstances will not create any special liability on the guilty party.

ILLUSTRATIONS. *(a) A,* having contracted with *B* to supply *B* 1,000 tons of iron at Rs 100 a ton, to be delivered at a stated time, contracts with *C* for the purchase of 1,000 tons of iron at Rs 80 a ton, telling *C* that he does so for the purpose of performing his contract with *B*. *C* fails to perform his contract with *A,* and *A* could not procure other iron, and *B*, in consequence rescinds the contract. *C* must pay to *A* Rs 20,000 being the profit which *A* would have made by the performance of his contract with *B*. [Illustration *(j)* to Section 73]. (If *C* was not told of *B*'s contract then only the difference in contract price and market price, if any, could be claimed.)

(b) A contracts with *B* to make and deliver to *B*, by a fixed day, for a specified price a certain piece of machinery. *A* does not deliver the piece of machinery at the time specified, and, in consequence of this, *B* is obliged to procure another at a higher price than that which he was to have paid to *A,* and is prevented from performing a contract which *B* had made with a third person at the time of his contract with *A*, (but which had not been then communicated to *A*), and is compelled to make compensation for breach of that contract. *A* must pay to *B*, by way of compensation, the difference between the contract price of the piece of machinery and the sum paid by *B* for another, but not the sum paid by *B* to the third person by way of compensation [Illustration *(k)* to Section 73].

(c) A, a builder, contracts to erect and finish a house by the first of January, in order that *B* may give possession of it at that time to *C*, to whom *B* has contracted to let it. *A* is informed of the contract between *B* and *C*. *A* builds the house so badly that, before the first of January, it falls down, and has to be rebuilt by *B,* who, in consequence loses the rent which he was to have received from *C*, and is obliged to make compensation for breach of that contract. *A* must pay to *B*, by way of compensation, *(i)* for the cost of rebuilding the house, *(ii)* for the rent lost, and (iii) for the compensation made to *C*. [Illustration *(l)* to Section 73]

3. **Exemplary or Vindictive Damages**

These are such damages which are awarded with a view to punishing the guilty party for the breach and not by way of compensation for the loss suffered by the aggrieved party. As observed earlier, the cardinal principle of the law of damages for a breach of contract is to compensate the injured party for the loss suffered and not to punish the guilty party. Hence, obvi-

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ously, exemplary damages have no place in the law of contract and are not recoverable for a breach of contract. There are, however, two exceptions to this rule:

(a) Breach of a contract to marry. In this case the amount of the damages will depend upon the extent of injury to the party's feelings. One may be ruined, other may not mind so much.

(b) Dishonour of a cheque by a banker when there are sufficient funds to the credit of the customer. In this case the rule of ascertaining damages is, "the smaller the cheque, the greater the damage." Of course, the actual amount of damages will differ according to the status of the party.

4. **Nominal Damages**

Nominal damages are those which are awarded only for the name sake. These are neither awarded by way of compensation to the aggrieved party nor by way of punishment to the guilty party. These are awarded to establish the right to decree for breach of contract when the injured party has not actually suffered any real damage and consist of a very small sum of money, say, a rupee or two. For example, where in a contract of sale of goods, if the contract price and the market price is almost the same at the date of breach of the contract, then the aggrieved party is entitled only to nominal damages.

Duty to Mitigate Damage Suffered

It is the duty of the injured party to mitigate damage suffered as a result of the breach of contract by the other party. He must use all reasonable means of mitigating the damage, just as a prudent man would, under similar circumstances in his own case. He cannot recover any part of the damage, traceable to his own neglect to mitigate. The onus of proof, however, is on the defendant to show that the plaintiff has failed in his duty of mitigation and the plaintiff is free from the burden of proving that he tried his best to mitigate the loss (*Pauzu, Ltd.* vs *Saunders*[4]).

"The rule in regard to mitigation must be applied with discretion and a man who has already put himself in the wrong by breaking his contract has no right to impose new and extraordinary duties on the aggrieved party."[5] "Courts should take care to see that they have put the plaintiff in the same position as if the contract had been performed, and have not been overgenerous to the contract-breaker by too severe an application of the rule that the plaintiff must take reasonable steps to mitigate damages."[6]

[4](1919), 2 K.B. 581.

[5]Pollock & Mulla on the *Indian Contract and Specific Relief Acts,* (8th ed.) at p. 468.

[6]*Ibid.*, p 472

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ILLUSTRATIONS. *(a)* Where a servant is dismissed, even though wrongfully, it is his duty to mitigate the damages by seeking other employment. He can recover only nominal damages if he refuses a reasonable offer of fresh employment. But if it cannot be proved that he has failed in his duty of mitigation, he will be entitled to the full salary for the whole of the unexpired period of service, if the contract of employment was for a fixed period. If the contract of employment was not for a fixed term, then the principle of awarding damages for a reasonable period of notice comes into play (*S. S. Shetty* vs *Bharat Nidhi Ltd.*[7]).

(b) A took a shop on rent from *B* and paid one month's rent in advance. *B* could not give possession of the shop to *A*. *A* chose to do no business for 8 months though there were other shops available in the vicinity. *A* sued *B* for breach of contract and claimed damages for the loss suffered. *Held,* he was entitled only to a refund of his advance, and nothing more, as he had failed in his duty to minimise the loss by not taking another shop in the neighbourhood (*Neki* vs *Pribhu*[8]).

Liquidated Damages and Penalty

Let us first know what we mean by the two terms. 'Liquidated damages' means a sum fixed up in advance, which is a fair and genuine pre-estimate of the probable loss that is likely to result from the breach. 'Penalty' means a sum fixed up in advance, which is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach. Thus the essence of a penalty is a payment of money stipulated as in *terrorem* of the offending party.

Sometimes the parties fix up at the time of the contract the sum payable as damages in case of breach. In such a case, a distinction is made in English Law as to whether the provision amounts to 'liquidated damages' or a 'penalty'. Courts in England usually allow 'liquidated damages' as stipulated in the contract, without any regard to the actual loss sustained. 'Penalty' clauses, however, are treated as invalid and the courts in that case calculate damages according to the ordinary principles and allow only reasonable compensation.

Under the Indian Law Section 74 does away with the distinction between 'liquidated damages' and 'penalty'. This Section lays down that the Courts are not bound to treat the sum mentioned in the contract, either by way of liquidated damages or penalty, as the sum payable as damages for the breach. Instead the courts are required to allow reasonable compensation so as to cover the actual loss sustained, not exceeding the amount so named in the contract. Thus, according to the Section, the named sum, regardless whether it is a penalty or not, determines only the maximum limit of liability in case of the breach of contract. The Section does not

[7]A.I.R. (1958). S.C. 12.
[8]100 I.C. 662.

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confer a special benefit upon any party; it merely declares the law that notwithstanding any term in the contract pre-determining damages or providing for forfeiture of any property by way of penalty, the Court will award to the party aggrieved only reasonable compensation not exceeding the amount named or penalty stipulated.

Exception. There is, however, one exception provided for by Section 74 to the above rule. When any person enters into any bailbond, recognizance or other instrument of the same nature, or under the provisions of any law or under the orders of the Government, gives any bond for the performance of any public duty or act in which the public are interested, he shall be liable to pay *the whole sum* mentioned therein upon breach of the condition of any such instrument.

ILLUSTRATIONS. *(a) A* contracts with *B* to pay Rs 1,000 if he fails to pay *B* Rs 500 on a given day. *A* fails to pay *B* Rs 500 on that day. *B* is entitled to recover from *A* such compensation, not exceeding Rs 1,000 as the court considers reasonable. [Illustration *(a)* to Section 74]

(b) A undertakes to repay *B* a loan of Rs 1,000 by five equal monthly instalments with a stipulation that, in default of payment of any instalment, the whole shall become due. This stipulation is not by way of penalty and the contract may be enforced according to its terms. [Illustration *(f)* to Section 74]

(c) A borrows Rs 100 from *B*, and gives him a bond for Rs 200 payable by five yearly instalments of Rs 40, with a stipulation that, in default of payment of any instalment, the whole shall become due. This is a stipulation by way of penalty. [Illustration *(g)* to Section 74]

Stipulation regarding payment of interest. The *Explanation* added to Section 74 states, "a stipulation for increased interest from the date of default may be a stipulation by way of penalty." It implies that such a stipulation may be considered a penalty clause and disallowed by the courts, if the enhanced rate is exorbitant.

ILLUSTRATION *[(d) to Sec. 74]. A* gives *B* a bond for the repayment of Rs 1,000 with interest at 12 percent per annum at the end of six months, with a stipulation that in case of default interest shall be payable at the rate of 75 per cent p.a. from the date of default. This is a stipulation by way of penalty and *B* is only entitled to recover from *A* such compensation as the court considers reasonable.

The following rules must also be noted in connection with payment of interest:

(a) Unless the parties have made a stipulation for the payment of interest, or there is a usage to that effect, interest cannot be recovered legally as damages, generally speaking (*Mahabir Prasad* vs *Durga Datta*[9]).

(b) Where a contract provides that the amount should be paid without interest by a particular date and on default it will be payable with interest,

[9]A.I.R. (1961), S.C. 990.

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such a stipulation may be allowed if the interest is reasonable. If the interest is exorbitant, the courts will give relief.

(c) Payment of compound interest on default, is allowed, only if it is not at an enhanced rate (*Bhushan Rao* vs *Subayya*[10]).

Earnest money. Money deposited as security for the due performance of a contract is known as earnest money. Forfeiture of earnest money is allowed if the amount is reasonable. But where it is in the nature of penalty, the court has jurisdiction to award such sum only as it considers reasonable but not exceeding the amount so agreed (*Fateh Chand* vs *Balkishen Dass*[11]). The proportion the amount bears to the total sale price, the nature of the contract and other circumstances have to be taken into account in ascertaining the reasonableness of the amount.

Cost of Suit

The aggrieved party is entitled, in addition to the damages, to get the costs of getting the decree for damages from the defaulter party. The cost of suit for damages is in the discretion of the court.

Summary of the Rules Regarding the Measure of Damages

The principles governing the measure of damages discussed above may be summarised as under:

1. The damages are awarded by way of compensation for the loss suffered by the aggrieved party and not for the purpose of punishing the guilty party for the breach.

2. The injured party is to be placed in the same position, so far as money can do, as if the contract had been performed.

3. The aggrieved party can recover by way of compensation only the actual loss suffered by him, arising naturally in the usual course of things from the breach itself.

4. Special or remote damages, *i.e.,* damages which are not the natural and probable consequence of the breach are usually not allowed until they are in the knowledge of both the parties at the time of entering into the contract.

5. The fact that damages are difficult to assess does not prevent the injured party from recovering them.

6. When no real loss arises from the breach of contract, only nominal damages are awarded.

7. If the parties fix up in advance the sum payable as damages in case of breach of contract, the court will allow only reasonable compensation so as to cover the actual loss sustained, not exceeding the amount so named in the contract.

[10](1936), 38 Bom. L.R. 1229 (P.C.)
[11]A.I.R. (1963), S.C. 1405.

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8. Exemplary damages cannot be awarded for breach of contract except in case of breach of contract of marriage or wrongful refusal by the bank to honour the customer's cheque.

9. It is the duty of the injured party to minimise the damage suffered.

10. The injured party is entitled to get the costs of getting the decree for damages from the defaulter party.

Suit Upon Quantum Meruit (Sections 65 and 70)

The third remedy for a breach of contract available to an injured party against the guilty party is to file a suit upon *quantum meruit.* The phrase *quantum meruit* literally means "as much as is earned" or "in proportion to the work done." A right to sue upon *quantum meruit* arises where a contract, partly performed by one party, has been discharged by breach of contract by the other party or, is discovered void or becomes void. This remedy may be availed of *either* without claiming damages (*i.e.*, claiming reasonable compensation only for the work done) *or* in addition to claiming damages for breach (*i.e.*, claiming reasonable compensation for part performance and damages for the remaining unperformed part).

The aggrieved party may file a suit upon *quantum meruit* and may claim payment in proportion to work done or goods supplied in the following cases:

1. Where work has been done in pursuance of a contract, which has been discharged by the default of the defendant.

ILLUSTRATIONS. *(a) P* agreed to write a volume on ancient armour to be published in a magazine owned by *C*. For this he was to receive $ 100 on completion. When he had completed part, but not the whole, of his volume, *C* abandoned the magazine. *P* was held entitled to get damages for breach of contract and payment *quantum meruit* for the part already completed (*Planche* vs *Colburn*[12]).

(b) A, engages *B*, a contractor, to build a three storied house. After a part is constructed *A* prevents *B* from working any more. *B*, the contractor, is entitled to get reasonable compensation for work done under the doctrine of *quantum meruit* in addition to the damages for breach of contract.

Notice that in both the above cases the contract was wrongfully terminated by the defendant, and both damages as well as payment *quantum meruit* have been allowed. It is important that in the case of a wrongful breach of contract the injured party can always claim payment *quantum meruit,* whether the contract is divisible or indivisible.

2. Where work has been done in pursuance of a contract which is 'discovered void' or 'becomes void,' provided the contract is divisible.

ILLUSTRATIONS. *(a) C* was appointed as managing director of a company by the board of directors under a written contract which provided for his remuneration. The contract was found void because the directors who constituted the 'Board'

[12](1831), 8 Bing. 14.

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were not qualified to make the appointment. *C* nevertheless, purporting to act under the agreement, rendered services to the company and sued for the sums specified in the agreement, or, alternatively, for a reasonable remuneration on a *quantum meruit*. *Held, C* could recover on a *quantum meruit*. (*Craven-Ellis* vs *Canons Ltd.*[13]).

(b) A contracts with *B* to repair his house at a piece rate. After a part of the repairs were carried out, the house is destroyed by lightning. Although the contract becomes void and stands discharged because of destruction of the house, *A* can claim payment for the work done on 'quantum meruit'. Note that if under the contract a lump sum is to be paid for the repair job as a whole, then *A* cannot claim *quantum meruit* because no money is due till the whole job is done.

3. When a person enjoys benefit of non-gratuitous act although there exists no express agreement between the parties. One of such cases is provided in Section 70.[14] Section 70 lays down that when services are rendered or goods are supplied by a person, *(i)* without any intention of doing so gratuitously, and *(ii)* the benefit of the same is enjoyed by the other party, the latter must compensate the former or restore the thing so delivered.

ILLUSTRATIONS. *(a) A*, a trader, leaves certain goods at *B*'s house by mistake. *B* treats the goods as his own. He is bound to pay *A* for them. [Illustration (*a*) to Section 70]

(b) Where *A* ploughed the field of *B* with a tractor to the satisfaction of *B* in *B*'s presence, it was held that *A* was entitled to payment as the work was not intended to be gratuitous and the other party has enjoyed the benefit of the same. (*Ram Krishna* vs *Rangoobert*[15]).

4. A party who is guilty of breach of contract may also sue on a *quantum meruit* provided both the following conditions are fulfilled:

(a) the contract must be divisible, and

(b) the other party must have enjoyed the benefit of the part which has been performed, although he had an option of declining it.

ILLUSTRATIONS. *(a)* Where a common carrier fails to take a complete consignment to the agreed destination, he may recover *pro-rata* freight. (He will, of course, be liable for breach of the contract.)

(b) S had agreed to erect upon *H*'s land two houses and stables for $ 565. *S* did part of the work and then abandoned the contract. *H* himself completed the buildings using some materials left on his land by *S*. In an action by *S* for the value of work done and of the materials used by *H*, it was held that *S* could recover the value of the materials (for *H* had the option to accept or to reject these) but he could not recover the value of the work done (for *H* had no option with regard to the partly erected building, but to accept that). The court observed, "The mere fact that a defendant is in possession of what he cannot help keeping, or even has done work

[13](1936), 2 K.B. 403.

[14]Section 70 has also been discussed under "Quasi Contracts". Refer to Chapter 11 for details.

[15]A.I.R. (1959), Bom. 519.

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upon it, affords no ground for such an inference. He is not bound to keep unfinished a building which in an incomplete state would be a nuisance on his land." (*Sumpter vs Hedges*[16]).

Suit for Specific Performance

Specific performance means the actual carrying out of the contract as agreed. Under certain circumstances an aggrieved party may file a suit for specific performance, *i.e.,* for a decree by the court directing the defendant to actually perform the promise that he has made. Such a suit may be filed either instead of or in addition to a suit for damages.

A decree for specific performance is not granted for contracts of every description. It is only where it is just and equitable so to do, *i.e.*, where the legal remedy is inadequate or defective, that the courts issue a decree for specific performance. It is usually granted in contracts connected with land, buildings, rare articles and unique goods having some special value to the party suing because of family association. Notice that in all these contracts monetary compensation is not an adequate relief because the injured party will not be able to get an exact substitute in the market.

Specific performance is not granted, as a rule, in the following cases:

(i) Where monetary compensation is an adequate relief. Thus the courts refuse specific performance of a contract to lend or to borrow money or where the contract is for the sale of goods easily procurable elsewhere.

(ii) Where the court cannot supervise the actual execution of the contract, *e.g.*, a building construction contract. Moreover, in most cases damages afford an adequate remedy.

(iii) Where the contract is for personal services, *e.g.,*a contract to marry or to paint a picture. In such contracts 'injunction' *(i.e.,* an order which forbids the defendant to perform a like personal service for other persons) is granted in place of specific performance.

(iv) Where one of the parties to the agreement does not possess competency to contract and hence cannot be sued for breach of contract. Thus a minor cannot succeed in an action for specific performance since he cannot himself be sued for breach of contract (*Lumley* vs *Ravenscroft*[17]).

Suit for an Injunction

'Injunction' is an order of a court restraining a person from doing a particular act. It is a mode of securing the specific performance of the *negative terms* of the contract. To put it differently, where a party is in breach of negative term of the contract (*i.e.,* where he is doing something

[16](1898), 1 Q.B. 673.
[17](1895), I Q.B. 683.

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which he promised not to do the court may, by issuing an injunction, restrain him from doing, what he promised not to do. Thus 'injunction' is a *preventive relief.* It is particularly appropriate in cases of 'anticipatory breach of contract' where damages would not be an adequate relief.

ILLUSTRATIONS. *(a) A*, agreed to sing at *B*'s theatre for three months from 1st April and to sing for no one else during that period. Subsequently she contracted to sing at *C*'s theatre and refused to sing at *B*'s theatre. On a suit by *B*, the court refused to order specific performance of her positive engagement to sing at the plaintiff's theatre, but granted an injunction restraining *A* from singing elsewhere and awarded damages to *B* to compensate him for the loss caused by *A*'s refusal. (*Lumley* vs *Wagner*[18])

(b) G agreed to take the whole of his supply of electricity from a certain company. The agreement was held to import a negative promise that he would take none from elsewhere. He was, therefore, restrained by an injunction from buying electricity from any other company (*Metropolitan Electric Supply Company* vs *Ginder*[19]).

TEST QUESTIONS

1. Discuss briefly the remedies for breach of contract.
2. What principles are applied in order to assess the amount of damages recoverable for a breach of contract?
3. "If a contract is broken, the law will endeavour, so far as money can do it, to place the injured party in the same position as if the contract has been performed." Discuss the statement indicating the rules which guide the court in the assessment of damages.
4. Explain the terms 'penalty' and 'liquidated damages' If the parties to a contract have agreed on the amount of damages payable in the event of its breach, can the court enhance or reduce that amount?
5. What is meant by suing on *quantum meruit?* Under what circumstances a claim on a *quantum meruit* arise?
6. When can an aggrieved party file a suit for 'specific performance' and for an 'injunction'? Explain and illustrate.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* contracts to pay a sum of money to *B* on a specified day. *A* does not pay the amount on that day. *B* in consequence of not receiving the money on that day, is unable to pay his debts and is totally ruined. *B* claims heavy damages. Advise *A*.

[**Hint.** *A* is liable to pay interest only from the specified day upto the date of payment. In other words *B* can claim only ordinary damages. *B* cannot claim heavy

[18](1852), I De G.M. & G. 604.
[19](1901), 2 Ch. 799.

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damages unless *A* had notice of the special circumstances resulting in the special loss at the time of entering into the contract.]

2. *A* agreed to erect a plant for *B* by 31st March, 1976. *A* further agreed to pay Rs 500 per month as damages in case of delay beyond the agreed date. *A* was late by four months. *B* sued *A* for Rs 4,500, the actual loss caused to him as a result of the delay. What damages will you award, and why?

[**Hint** *B* is entitled to recover Rs 2,000 only, because when a sum is named in the contract as the amount to be paid in case of breach, the court will allow only reasonable compensation so as to cover the actual loss sustained, within the limits stated in the contract.]

3. *A* employs *B* as manager of his factory for a term of three years at a monthly salary of Rs 3,000. Without any lapse on the part of *B*, *A* dismisses him after two years of service. *B* could not get an alternate job elsewhere and files a suit for damages for breach of contract against *A*. Will he succeed? If yes, assess the amount of damages recoverable by him.

[**Hint**. Yes, *B* will succeed. If it cannot be proved that *B* has failed in his duty to mitigate the loss subsequent upon the breach, *B* will be entitled to full salary for the whole of the unexpired period of service *i.e.*,one year. Hence the amount of damages recoverable by *B* amounts to Rs 36,000.]

4. A mate was engaged for a lump sum to be paid after the completion of voyage. The mate dies when only 2/3 of the voyage was completed. His legal representatives claim damages on *quantum meruit.* Decide.

[**Hint**. The legal representatives of the mate cannot recover anything as the doctrine of *quantum meruit* is inapplicable under the circumstances (*Cutter* vs *Powell,* 6 T.R. 320). The rule of law on the point is that 'party in default' cannot sue upon *quantum meruit,* if the contract is '*indivisible'* and a lump sum is to be paid for the job as a whole, because no money is due till the job is done.]

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Chapter 13

Indemnity and Guarantee

CONTRACTS OF INDEMNITY

Definition

"A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a contract of indemnity" (Section 124).

A contract of indemnity is really a part of the general class of 'contingent contracts.' It is entered into with the object of protecting the promisee against anticipated loss. The contingency upon which the whole contract of indemnity depends is the happening of loss.

The person who promises to make good the loss is called the 'indemnifier' (promisor), and the person whose loss is to be made good is called the 'indemnified or indemnity-holder' (promisee).

ILLUSTRATIONS. *(a)* The R/R (Railway Receipt) pertaining to certain goods is lost by *B*. *A* as also *B* claim the goods from Railway Company. In view of the rival claimants of goods, the Railway Co. asked *A* to give an 'indemnity bond'. *A*, accordingly, gets the goods on executing the 'indemnity bond.' *A* is the *indemnifier* and the Railway Co. is the *indemnity-holder*. Later, *B*, the real owner, sues the Railway Co. for damages and gets a decree against the Railway Co.. The Railway Co. (indemnity-holder) can claim indemnity from *A*, the indemnifier, for the loss caused to it by his conduct.

(b) *A* lost his share certificate. He applied to the company for the issue of a duplicate certificate. The Company asked *A* to furnish an 'indemnity bond' in its favour to protect it against any claim that may be made by any person on the original certificate. *A*, accordingly executed the 'indemnity bond'. It is a contract of indemnity between *A* and the Company. *A* is the 'indemnifier' and the Company is the 'indemnified' or 'indemnity-holder'.

(*C*) *A* contracts to indemnify *B* against the consequences of any proceedings which *C* may take against *B* in respect of a certain sum of Rs 200. This is a contract of indemnity (Illustration to Section 124). *A* is the 'indemnifier' and *B* is the 'indemnified'. (For the sake of clarity we further elucidate the illustration. The background of the instant contract of indemnity might have been a situation like this: *B* owed Rs 200 to *C* on a promissory note. On the date of payment *C* could not return the promissory note (which was lost) to *B* and hence *A* assured *B* that

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no suit will be filed later by *C* in respect of the sum and requested *B* to make the payment without insisting on getting back the promissory note and promised to indemnify *B* against the consequences of any suit which *C* may file against *B* in that regard. As a result *B* makes the payment. *B's* paying to *C* as per the desire of *A* is the consideration moving from *B's* side and *A's* promise to indemnify *B* is the consideration moving from *A*'s side. It is a contract of indemnity between *A* and *B*, if *A did all this of his own, without any request from C.* Should *C* file a suit against *B* in respect of the sum and *B* is ordered to pay to *C* Rs 200 plus the costs of the suit, *A* shall be required to pay *B* the total amount under the present contract of indemnity.)

It is to be noted that a person may undertake to save the other from loss caused to him, by the conduct of a third person *either* at the request of the third person *or* without any request from such third person. In the first case there would be a 'contract of guarantee' and the third person would be responsible to the surety. In the latter case there would be a 'contract of indemnity' and the third person (debtor) cannot be held responsible to the indemnifier, as there is 'no privity of contract' between them.[1]

A contract of indemnity, being a species of contract, must have all the essential elements of a valid contract; and an indemnity given under coercion or for an illegal object cannot be enforced. Further, a contract of indemnity may be *express or implied.* For example, there is an implied promise to indemnify agent by the principal in a contract of agency. Similarly, when shares are transferred the transferee is impliedly bound to indemnify the transferor against future calls made before the registration of transfer.

Rights of Indemnity-holder When Sued (Sec. 125)

For the sake of clarity we shall be discussing the rights of indemnity-holder when sued with the help of an example. Suppose a vendor contracts to indemnify the vendee against the costs of litigation if title to the property is disturbed, and the vendee is sued by a rival owner, then the vendee *i.e.*, the indemnity-holder has the following rights against the vendor *i.e.*, the indemnifier:

1. He is entitled to recover all damages which he may be compelled to pay in respect of suit to which the promise to indemnify applies.
2. He is entitled to recover all costs reasonably incurred, in bringing or defending such suit, provided he acted prudently or with the authority of the promisor (indemnifier).
3. He is also entitled to recover all sums which he may have paid under the terms of any compromise of any such suit, provided the compromise was not contrary to the orders of the indemnifier and was prudent or was authorised by the promisor (indemnifier).

[1]Adapted from T.R. Desai's *Contract Act, etc.* 18th edn. 197[illegible] 302.

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principal debtor, may be a sufficient consideration to the surety for giving the guarantee."

ILLUSTRATIONS (appended to Sec. 127). *(a) B* requests *A* to sell and deliver to him goods on credit. *A* agrees to do so, provided *C* will guarantee the payment of the price of the goods. *C* promises to guarantee the payment in consideration of *A's* promise to deliver the goods. This is sufficient consideration for *C's* promise.

(b) A sells and deliver goods to *B*, *C* afterwards requests *A* to forbear to sue *B* for the debt for a year, and promises that if he does so, *C* will pay for them in default of payment by *B*. *A* agrees to forbear as requested. This is a sufficient consideration for *C's* promise.

(c) A sells and delivers goods to *B*. *C* afterwards, without consideration, agrees to pay for them in default of *B*. The agreement is void.

The third illustration to the Section (as reproduced above) implies that a guarantee for a past debt would be invalid. There must be some fresh consideration moving from the creditor at the time of guarantee, *e.g.*, a further advance is made or the creditor refrains from suing the principal debtor on the payment having become due; in order to constitute a valid contract of guarantee. But in the case of a further advance the surety must clearly undertake the liability for the total debt including the past debt (*Bank of Scotland* vs *Morrison*[7]).

Distinction between a Contract of Indemnity and a Contract of Guarantee

The following are the points of distinction between the two:

1. In a contract of indemnity, there are two parties — the indemnifier and the indemnity-holder. In a contract of guarantee, there are three parties — the creditor, the principal debtor and the surety.

2. In a contract of indemnity, the liability of the indemnifier is primary in nature. In a contract of guarantee, the liability of the surety is secondary, *i.e.*, the surety is liable only on default of the principal debtor. (If the principal debtor fulfils his obligation, the question of surety's liability does not arise.)

3. In a contract of indemnity, the indemnifier acts independently without any request of the debtor or the third party, whereas in a contract of guarantee it is necessary that the surety should give the guarantee at the request of the debtor.

4. In a contract of indemnity, in most cases the liability of the indemnifier arises only on the happening of a contingency, whereas in a contract of guarantee there is an existing legal debt or duty, the performance of which is guaranteed by the surety.

[7](1911), S.C. 593.

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5. In a contract of guarantee, the surety, after he discharges the debt owing to the creditor, can proceed against the principal debtor in his own right. But in the case of a contract of indemnity, the indemnifier cannot sue the third party for loss in his own name, because there is no privity of contract. He can do so only, if there is as assignment in his favour, otherwise he must bring the suit (against the third party) in the name of the indemnified.

6. A contract of indemnity is for the reimbursement of loss, where-as a contract of guarantee is for the security of a debt or good conduct of an employee.

7. In indemnity there is only one contract between the indemnifier and the indemnified, while in guarantee, there are three contracts — one between the principal debtor and the creditor, the second between the creditor and the surety, and the third between the surety and the principal debtor.

Nature and Extent of Suerty's Liability

Regarding the extent of the surety's liability Section 128 provides, thus "the liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract." The phrase "co-extensive with that of the principal debtor" shows the quantum of the surety's liability. Accordingly, the quantum of obligation of a surety is the same as that of a principal debtor, unless there is a contract to the contrary. In general, it will be neither more nor less, although by a special contract it may be made less than that of the principal debtor, but never greater.

ILLUSTRATION. *A* guarantees to *B* the payment of a bill of exchange by *C*, the acceptor. The bill is dishonoured by *C*. *A* is liable not only for the amount of the bill and interest thereon, but also for the notarial charges which may have been incurred for noting and protesting the bill. (Adapted from the illustration appended to Section 128.)

Section 128 provides only for the maximum extent of the surety's liability and it does not deal with the nature of surety's liability. For this, we have to depend upon some other provisions of the Contract Act and judicial decisions; on the basis of which the following generalisations can be made regarding the nature of surety's liability:

1. The liability of a surety is secondary or contingent, *i.e.*, the surety is liable only on default of the principal debtor. Thus, if the surety becomes insolvent before default by the principal debtor (*i.e.*, before the date on which the debt is due for repayment), the creditor cannot prove against the surety's 'official receiver' in insolvency.

2. The liability of the surety arises immediately on the default of the principal debtor, unless there is an express provision in the contract that the creditor must in the first instance proceed against the principal debtor or

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must give a notice of default to the surety. If the contract is silent, the creditor may file a suit against the surety directly without suing the principal debtor or without making the principal debtor as co-defendant. In other words, the creditor is not bound to exhaust his remedies against the principal debtor before suing the surety (*Bank of Bihar* vs *Damodar Prasad*[8]). The logic behind this rule is that, in law, it is the surety's duty to see that the principal debtor fulfils his obligation. Therefore, as soon as the time for payment has come and the principal debtor does not or is unable to pay or perform his obligation, the surety becomes liable directly, unless otherwise agreed.

3. Where a creditor holds securities from the principal debtor for his debt, the creditor need not first resort to these securities before suing the surety, unless otherwise agreed.

4. The surety will not be liable where the creditor has obtained guarantee by misrepresenting (either innocently or knowingly) a material part of the transaction or by keeping silence as to material circumstance, *e.g.*, obtaining guarantee for the conduct of an employee without disclosing to the surety his previous dishonesty (Sections 142-143).

5. The law treats two separate contracts in a contract of guarantee from creditor's point of view *i.e.* , one between the creditor and principal debtor and the other between the creditor and surety. In other words, the law does not treat the principal debtor and surety as one person, and there is no such thing that the surety will be liable only if the principal debtor is liable. One may be liable while the other may not be. For example:

(i) If some variation in the contract is done later on by the creditor and principal debtor, without surety's consent, the surety is not liable while the principal debtor is liable.

(ii) An admission by the principal debtor is no evidence against the surety or a judgement obtained against the principal debtor will not be enforceable against the surety, unless otherwise agreed. A surety's liability must be proved by a suit on him independent of any admission by the principal debtor or taking him as a co-defendant (*Rambhajan* vs *Sheo Prasad*[9]).

(iii) A debt may become time-barred as against the principal debtor, but the surety may still be liable, if he has kept his own liability alive by *bonafide* payment of interest or part of the principal sum within the period of limitation (*Raghavendra* vs *Mahipal*[10]). Of course, in such a case, after paying the creditor, the surety is entitled to recover the amount from the

[8]A.I.R. (1969), S.C. 297.
[9]A.L.J. 142.
[10](1925), 49Bom. 202.

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principal debtor, as the sum so paid was paid rightfully within the meaning of Section 145. It may be noted that if a debt has become time-barred as against both the principal debtor and surety, then none of the two is liable to the creditor. If the surety pays such a debt he cannot recover it from the principal debtor, because the sum so paid was paid wrongfully within the meaning of Section 145 (*Tarachand Lakhmichand* vs *Gopal*[11]).

(iv) A discharge of the principal debtor by operation of law *e.g.*, insolvency, does not discharge the surety. The surety remains liable for the full amount of debt (*Bank of India Ltd.*vs *R.F. Cowasjee*[12]). However, when liability of the principal debtor is scaled down under Debt Relief Act, surety's liability is also reduced (*Narayan Singh* vs *Chhatar Singh*[13]).

Continuing Guarantee

A guarantee may be an 'ordinary guarantee' or a 'continuing guarantee.' When a guarantee is given for a single specific debt or transaction, it is called an 'ordinary or specific guarantee.' It comes to an end as soon as the liability under that transaction ends. When a guarantee extends to a series of distinct and separable transactions, it is called a 'continuing guarantee' (Sec. 129). The guarantee given here is intended to cover a number of transactions over a period of time. It is just like a standing offer which is accepted by the creditor every time a subsequent transaction takes place. Being a standing offer it may be revoked at any time by the surety as to future transactions (*i.e.,* acceptances).

ILLUSTRATIONS. (*a*) *A* guarantees to *C* for *B's* credit purchases with a running balance of account not exceeding Rs. 5,000. This is a continuing guarantee.

(*b*) *A* guarantees to *C* for *B's* purchases from *C* for six months to the extent of Rs. 5,000. This is a continuing guarantee.

(*c*) *A,* in consideration that *B* will employ *C* in collecting the rents of *B's* Zamindari, promises *B* to be responsible, to the amount of Rs. 5,000, for the due collection and payment by *C* of those rents. This is a continuing guarantee. [Illustration (*a*) to Section 129]

The following points deserve special attention in connection with a continuing guarantee:

1. A continuing guarantee is not exhausted by the first advance or credit upto the guarantee limit.

ILLUSTRATION [(*b*) appended to Sec. 129]. *A* guarantees payment to *B,* a tea dealer, to the amount of £ 100, for any tea he may *from time to time* supply to *C. B* supplies *C* with tea to the above value of £100, and *C* pays *B* for it. Afterwards *B* supplies *C* with tea to the value of £200. *C* fails to pay. The guarantee

[11]A.I.R. (1959), M.P.297.
[12]A.I.R. (1955). Bom. 419.
[13]A.I.R. (1973), Raj. 347.

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given by *A* was a continuing guarantee, and he is accordingly liable to *B* to the extent of £100.

2. Whether or not a guarantee is a continuing one depends upon the intention of the parties, as expressed by the terms of the contract and the surrounding circumstances.

ILLUSTRATION [(*c*) appended to Section 129]. *A* guarantees payment to *B* of the price of five sacks of flour to be delivered by *B* to *C* and to be paid for in a month. *B* delivers five sacks to *C*. *C* pays for them. Afterwards *B* delivers four sacks to *C*, which *C* does not pay for. The guarantee given by *A* was not a continuing guarantee, and accordingly he is not liable for the price of the four sacks.

3. The essence of a continuing guarantee is that it applies to a series of distinct and separable transactions. As such a guarantee given for an *entire consideration* is not a continuing guarantee.

ILLUSTRATIONS. *(a) A* leased certain property to *B* for five years on a specified rent and *C* executed a contract of guarantee in favour of *A* ensuring thereby the due fulfilment of *B's* engagements. *B* having failed to pay rent for two years, *A* sued him and got a decree. Thereafter *C* gave a notice to *A* revoking his guarantee for the remaining period of the lease. *Held,* that this was not a continuing guarantee and *C* was not competent to revoke it. The guarantee was treated as a specific guarantee because "lease for five years" was an entire or indivisible consideration and not a fragmented one. In a way it was a guarantee for the payment by instalments of a certain sum within a definite time and therefore was not a continuing guarantee (*Hasan Ali* vs *Wali Ullah*[14]).

(*b*) A guarantee of the fidelity of a person appointed to a place of thrust, *e.g.*, the post of Khajanchi in a bank, is not a continuing guarantee and so long as the person is there in the bank the guarantee cannot be revoked (*Sen* vs *Bank of Bengal*[15]).

Revocation of Continuing Guarantee

A continuing guarantee may be revoked as regards future transactions under the following circumstances:

1. **By notice of revocation by the surety.** Section 130 provides that "a continuing guarantee may, at any time, be revoked by the surety, as to future transactions, by notice to the creditor." Thus the surety, may terminate his continuing guarantee as regards transactions entered into after the notice. He continues to be liable for transactions entered into prior to the notice.

ILLUSTRATION [(*a*) appended to Section 130]. *A*, in consideration of *B's* discounting, at *A's* request, bill of exchange for *C*, guarantees to *B*, for twelve months, the due payment of all such bills to the extent of Rs. 5,000. *B* discounts bills for *C* to the extent of Rs 2,000. Afterwards, at the end of three months *A* revokes the guarantee. This revocation discharges *A* from all liabilities to *B* for any subsequent discounting of bills. But *A* is liable to *B* for Rs 2,000, on default of *C*.

[14](1930), 28 All. L.J. 1271.
[15]32 C.L.J. 223 (P.C.).

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2. **By death of surety.** Section 131 lays down that "the death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee, so far as regards future transactions." Accordingly, a continuing guarantee is also terminated by the death of the surety so far as regards future transactions unless there is a contract to the contrary. It is not necessary that the creditor must have notice of the death. The estate of the surety is free after death, although the creditor might have entered into a transaction without knowledge of the death of the surety.

3. **In the same manner as the surety is discharged.** A continuing guarantee is also revoked under the same circumstances under which a surety's liability is discharged, that is:

(*a*) By variance in terms of contract (Section 133).

(*b*) By release or discharge of principal debtor (Section 134).

(c) By arrangement with principal debtor (Section 135).

(*d*) By creditor's act or omission impairing surety's eventual remedy (Section 139).

(*e*) By loss of security (Section 141).

These have been discussed later under the heading "Discharge of Surety from Liability."

Rights of Surety

A surety has certain rights against the creditor, principal debtor and co-sureties.

Surety's rights against the creditor. The surety enjoys the following rights against the creditor:

1. *Right to benefit of creditor's securities* (Section 141). The surety is entitled to demand from the creditor, at the time of payment, all the securities which the creditor has against the principal debtor at the time when the contract of suretyship is entered into or subsequently acquired. Whether the surety knows of the existence of such security or not is immaterial. If by negligence the creditor loses or, without the consent of the surety, parts with such security as *acquired at the time of contract,* the surety is discharged to the extent of the value of security. But if the security is lost due to an act of God or enemies of the State or unavoidable accident, the surety would not be discharged (*Krishan Talwar* vs *Hindustan Commercial Bank*[16]). Similarly, if the subsequently acquired securities are parted with, the liability of the surety would not be reduced (*Bhushayya* vs *Suryanarayan*[17]).

It is to be remembered that the surety is entitled to the benefit of the

[16]A.I.R. (1957), Punjab, 30.

[17](1944), Mad. 340.

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securities only after paying the debt in full. He cannot claim the benefit of a part of the securities merely because he has paid a part of the debt (*Goverdhandas* vs *Bank of Bengal*[15]).

ILLUSTRATIONS (appended to Section 141). (*a*) *C* advances to *B*, his tenant, Rs. 2,000 on the guarantee of *A*. *C* has also a further security for the 2,000 rupees by a mortgage of *B*'s furniture, *C* cancels the mortgage, *B* becomes insolvent, and *C* sues *A* on his guarantee. *A* is disharged from liability to the amount of the value of the furniture.

(*b*) *C*, a creditor, whose advance to *B* is secured, by a decree, receives also a guarantee for that advance from *A*. *C* afterwards takes *B's* goods in execution under the decree, and then, without the knowledge of *A* withdraws the execution. *A* is discharged.

(*c*) *A*, as surety for *B*, makes a bond jointly with *B* to *C*, to secure a loan from *C* to *B*. Afterwards *C* obtains from *B* a further security for the same debt. Subsequently, *C* gives up the further security. *A* is not discharged.

2. *Right to claim set-off, if any.* The surety is also entitled to the benefit of any set-off or counter claim, which the principal debtor might possess against the creditor in respect of the same transaction.

Surety's rights against the principal debtor. The surety enjoys the following two rights against the principal debtor:

1. *Right of subrogation* (Section 140). When the surety pays off the debt on default of the principal debtor, he is invested with all the rights which the creditor had against the principal debtor. The surety steps into the shoes of the creditor and is entitled to all the remedies which the creditor could have enforced against the principal debtor. The surety may therefore, claim the securities, if any, held by the creditor and sue the principal debtor, or may claim dividend in insolvency of the debtor.

2. *Right to claim indemnity* (Section 145). "In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety; and the surety is entitled to recover from the principal debtor whatever sum he has 'rightfully paid' under the guarantee, but no sums which he had paid wrongfully." Thus a surety is entitled to be indemnified by the principal debtor for whatever sum he has 'rightfully paid' under the guarantee.

The expression 'rightfully paid' means a just and equitable payment. It covers the principal sum, interest thereon, noting charges in case of a bill of exchange, and costs of the suit if there are reasonable grounds to defend the suit. It does not cover unjust payment like the payment made of a debt which is time barred as against both the principal debtor and surety.

The following two points must also be noted in connection with this right to indemnity:

(*a*) The surety cannot claim more than what he has actually paid to the

[15](1891), 15 Bom. 48.

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creditor. Thus if he discharges the debt by compromise at less than its full amount, he can get from the principal debtor only the amount actually paid.

(*b*) Actual payment either in cash or by transfer of property is essential for asking the principal debtor to pay. A promissory note given by the surety will not be sufficient to claim indemnity.

ILLUSTRATIONS (appended to Section 145). (*a*) *B* is indebted to *C*, and *A* is surety for the debt. *C* demands payment from *A*, and on his refusal sues him for the amount. *A* defends the suit, having reasonable grounds for doing so (some variation in terms later might be *A's* plea), but is compelled to pay the amount of the debt with costs. He can recover from *B* the amount paid by him for costs, as well as the principal debt.

(*b*) *C* lends *B* a sum of money, and *A*, at the request of *B*, accepts a bill of exchange[19] drawn *by B* upon *A* to secure the amount. *B* then endorses the bill to *C*. *C*, the holder of the bill, demands payment of it from *A*, and on *A's* refusal to pay, sues him upon the bill. *A*, not having reasonable grounds for so doing, defends the suit and has to pay the amount of the bill and costs. *A* can recover from *B* the amount of the bill, but not the sum paid for costs, as there was no real ground for defending the action.

(*c*) *A* guarantees to *C* as regards payment for rice to be supplied by him to *B* upto the extent of Rs 2,000. *C* supplies to *B* rice to a less amount than Rs 2,000 but obtains from *A* payment of the sum of Rs 2,000 in respect of the rice supplied. *A* cannot recover from *B* (principal debtor) more than the price of the rice actually supplied. (Of course *A* might recover from *C* the excess paid under Section 72 — "Payment made under a mistake or coercion can be taken back.")

Surety's rights against co-sureties. Where a debt is guaranteed by more than one sureties, they are called co-sureties. In such a case all the co-sureties are liable to contribute towards the payment of the guaranteed debt as per agreement among them. But in the absence of any agreement, if one of the co-sureties is compelled to pay the entire debt, he has a right of contribution from the other co-surety or co-sureties. The rules of contribution are laid down in Sections 146-147 which are as follows:

1. *Where they are sureties for the same debt for similar amount* (*i.e.*, for one and the same amount), the co-sureties are liable to contribute equally, and are entitled to share the benefit of securities, if any, held by any one of the co-sureties, equally. To sum up the principle it may be said, "As between co-sureties, there is equality of burden and benefit." Further, for the application of the principle it is immaterial whether the sureties are liable jointly under one contract or severally under several contracts, and whether with or without the knowledge of each other. There is, however, no right of contribution between persons who become sureties *not for the same debt* but for different debts.

[19]The bill of exchange in question is technically called an 'Accommodation Bill.'

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ILLUSTRATIONS (appended to Section 146). (*a*) *A, B, and C* are sureties to *D* for the sum of Rs 3,000 lent to *E*. *E* makes default in payment. *A, B* and *C* are liable, as between themselves, to pay Rs 1,000 each. (If *C* is insolvent and could pay only Rs 500, then *A* and *B* will contribute equally to make good his loss.)

(*b*) *A, B and C* are sureties to *D* for the sum of Rs 1,000 lent to *E*, and there is a contract between *A, B,* and *C* that *A* is to be responsible to the extent of one-quarter, *B* to the extent of one-quarter, and *C* to the extent of one-half. *E* makes default in payment. As between the sureties, *A* is liable to pay Rs. 250, *B* Rs. 250 and C Rs 500.

2. *Where they are sureties for the same debt for different sums,* the rule is that "subject to the limit fixed by his guarantee, each surety is to contribute equally, (and not proportionately to the liability undertaken)."

ILLUSTRATION (appended to Section 147). *A, B, and C,* as sureties for D, enter into three several bonds each in a different penalty, namely, *A* in the penalty of Rs 10,000, *B* in that of Rs 20,000 and *C* in that of Rs 40,000, conditioned for *D's* duly accounting to *E*. Then,

(*i*) if *D* makes default to the extent of Rs 30,000, *A,B, and C* are each liable to pay Rs 10,000;

(*ii*) if *D* makes default to the extent of Rs 40,000, *A* is liable to pay Rs 10,000 (his maximum limit of liability), and *B* and *C* Rs 15,000 each;

(*iii*) if *D* makes default to the extent of Rs 60,000, then *A* is liable to pay Rs 10,000, *B* Rs 20,000 and *C* Rs 30,000; and

(*iv*) if *D* makes default to the extent of Rs 70,000, then *A, B* and *C* have to pay each the full penalty of his bond.

Discharge of Surety from Liability

A surety is freed from his obligation under a contract of guarantee under any one of the following circumstances:

1. **Notice of revocation**. An 'ordinary guarantee' for a single specific debt or transaction cannot be revoked once it is acted upon. But a 'continuing guarantee' may at any time, be revoked by the surety as to future transactions, by giving notice to the creditor (Sec. 130). Thus, in such a case, the liability of the surety comes to an end in respect of future transactions which may be entered into by the principal debtor after the surety has served the notice of revocation. The surety shall, however, continue to remain liable for transactions entered into prior to the notice.

2. **Death of surety** (Sec. 131). In case of a 'continuing guarantee' the death of a surety also discharges him from liability as regards transactions after his death, unless there is a contract to the contrary. The deceased surety's estate will not be liable for any transaction entered into after the death, even if the creditor has no notice of the death.

3. **Variance in terms of contract** (Sec. 133). "Any variance, made without the surety's consent in the terms of the contract between the principal debtor and the creditor, discharges the surety as to transactions sub-

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sequent to the variance." Although the words "as to transactions subsequent to the variance" are more pertinent in the case of 'continuing guarantee', but the principle as laid down in the Section is equally applicable in 'specific guarantee' as well. Thus a surety is discharged from liability when, without his consent, the creditor makes any change in the terms of his contract with the principal debtor (no matter whether the variation is beneficial to the surety or is made innocently or does not materially affect the position of the surety[20]) because a surety is liable only for what he has undertaken in the contract. "Surety has a right to say: The contract is no longer that for which I engaged to be surety; you have put an end to the contract that I guaranteed, and my obligation, therefore, is at an end."[21] It is important to note that mere knowledge and silence of the surety does not amount to an implied consent (*Polak* vs *Everett*[22].) Again, accepting further security for the same debt is not treated as variance in terms of contract.

ILLUSTRATIONS (appended to Sec. 133). (*a*) *A* becomes surety to *C* for *B's* conduct as a manager in *C's* bank. Afterwards, *B* and *C* contract, without *A's* consent, that *B's* salary shall be raised, and that he shall become liable for one-fourth of the losses on overdrafts. *B* allows a customer to overdraw, and the bank loses a sum of money. *A* is discharged from his suretyship by the variance made without his consent, and is not liable to make good this loss.

(*b*) *A* guarantees *C* against the misconduct of *B* in an office to which *B* is appointed by *C*, and of which the duties are defined by an Act of the Legislature. By a subsequent Act, the nature of the office is materially altered. Afterwards, *B* misconducts himself. *A* is discharged, by the change, from future liability under his guarantee, though the misconduct of *B* is in respect of a duty not affected by the later Act.

(*c*) *C* agrees to appoint *B* as his clerk to sell goods at a yearly salary, upon *A's* becoming surety to *C* for *B's* duly accounting for moneys received by him as such clerk. Afterwards, without *A's* knowledge or consent, *C* and *B* agree that *B* should be paid by a commission on the goods sold by him and not by a fixed salary. *A* is not liable for subsequent misconduct of *B*.

(*d*) *C* contracts to lend *B* Rs 5,000 on the first March. *A* guarantees, repayment. *C* pays the 5,000 rupees to *B* on the first January. *A* is discharged from his liability, as the contract has been varied in as much as *C* might sue *B* for the money before the first of March.

4. **Release or discharge of principal debtor** (Sec. 134). This Section provides for the following two ways of discharge of surety from liability:

(*a*) The surety is discharged by *any contract* between the creditor and the principal debtor, by which the principal debtor is released. Any release of the principal debtor is a release of the surety also.

[20]See Illustration (*b*) given below.
[21]Lord Westbury L.C. in *Blest vs Brown,* (1862) 4 De. G.F. & J. 367.
[22]1 Q.B.D. 669.

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(*b*) The surety is also discharged by *any act or omission* of the creditor, the legal consequence of which is the discharge of the principal debtor.

ILLUSTRATIONS (appended to Sec. 134). (*a*) *A* gives a guarantee to *C* for goods to be supplied by *C* to *B*. *C* supplies good to *B*, and afterwards *B* becomes embarrassed and contracts with his creditors (including *C*) to assign to them his property in consideration of their releasing him from their demands. Here *B* is released from his debt by the contract with *C*, and *A* is discharged from his suretyship.

(*b*) *A* contracts with *B* for a fixed price to build a house for *B* within a stipulated time, *B* supplying the necessary timber. *C* guarantees *A's* performance of the contract. *B* omits to supply the timber. *C* is discharged from his suretyship (because the contract stands discharged against *A*, the contractor).

5. **Arrangement by creditor with principal debtor without surety's consent** (Sec. 135). Where the creditor, without the consent of the surety, makes an arrangement with the principal debtor for composition, or promises to give him time or not to sue him, the surety will be discharged.

But in the following cases, a surety is not discharged:

(*a*) Where a contract to give time to the principal debtor is made by the creditor with a third person, and not with principal debtor, the surety is not discharged (Sec. 136).

ILLUSTRATION (to Sec. 136). *C*, the holder of an overdue bill of exchange drawn by *A* as surety for *B* and accepted by *B*, contracts with *M* to give time to *B*. *A* is not discharged.

(*b*) Mere forbearance on the part of the creditor to sue the principal debtor, or to enforce any other remedy against him, does not discharge the surety, unless otherwise agreed (Sec. 137).

ILLUSTRATION (to Sec. 137). *B* owes to *C* a debt guaranteed by *A*. The debt becomes payable, *C* does not sue *B* for a year after the debt has become payable. *A* is not discharged from the suretyship.

(*c*) Where there are co-sureties, a release by the creditor of one of them does not discharge the others; neither does it free the surety so released from his responsibility to the other sureties (Sec. 138).

6. **Creditor's act or omission impairing surety's eventual remedy** (Sec. 139). "If the creditor does any act which is inconsistent with the rights of the surety, or omits to do any act which his duty to the surety requires him to do, and the eventual remedy of the surety himself against the principal debtor is thereby impaired, the surety is discharged." In short, it is the duty of the creditor to do every act necessary for the protection of the rights of the surety and if he fails in this duty, the surety is discharged. Thus, where the integrity of a cashier is guaranteed, it is the duty of the employer to give information to the surety if any dishonest act is done by the employee. If the employer continues to employ him after an act of dishonesty (which is proved), the surety is discharged, if he is not informed

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within a reasonable time, because then the surety's right (eventual remedy) to inform police for necessary recovery action is lost or damaged *i.e.*, may not be so fruitful as it would have been, had a report been lodged earlier.

ILLUSTRATIONS (appended to Sec. 139). *(a) B* contracts to build a ship for *C* for a given sum, to be paid by instalments as the work reaches certain stages, (the last instalment not to be paid before the completion of the ship). *A* becomes surety to *C* for *B's* due performance of the contract. *C*, without the knowledge of *A*, prepays to *B* the last two instalments. *A* is discharged by this prepayment.

(*b*) *A* puts *M* as an apprentice to *B* and gives a guarantee to *B* for *M's* fidelity. *B* promises on his part that he will, at least once a month, see *M* make up the cash. *B* omits to see this done as promised, and *M* embezzles. *A* is not liable to *B* on his guarantee.

7. **Loss of security** (Sec. 141). If the creditor loses or, without the consent of the surety, parts with any security given to him, at the time of the contract of guarantee, the surety is discharged from liability to the extent of the value of security. The word 'loss' here means loss because of carelessness or negligence. Thus if the security is lost due to an act of God or enemies of the state or unavoidable accident, the surety would not be discharged. Again, if the securities lost or parted with, were obtained afterwards as a further security, the surety would not be discharged (*Bhushayya* vs *Suryanarayan*[23]).

8. **Invalidation of the contract of guarantee** (in between the creditor and the surety). A surety is also discharged from liability when the contract of guarantee (in between the creditor and the surety) is invalid. A contract of guarantee is invalid in the following cases:

(*i*) Where the guarantee has been obtained by means of misrepresentation or fraud or keeping silence as to material part of the transaction, by the creditor or with creditor's knowledge and assent (Secs. 142 & 143). Notice that under these Sections the guarantee remains valid if the misrepresentation or concealment is done by the debtor without the concurrence of the creditor.

ILLUSTRATIONS (appended to Sec. 143). (*a*) *A* engages *B* as clerk to collect money for him. *B* fails to account for some of his receipts, and *A*, in consequence, calls upon him to furnish security for his duly accounting. *C* gives his guarantee for *B's* duly accounting. *A* does not acquaint *C* with *B's* previous conduct. *B* afterwards makes default. The guarantee is invalid.

(*b*) *A* guarantees to *C* payment for iron to be supplied by him to *B* to the amount of 2,000 tons. *B* and *C* have privately agreed that *B* should pay five rupees per ton beyond the market price, such excess to be applied in liquidation of an old debt. This agreement is concealed from *A*. *A* is not liable as a surety.

(*ii*) Where a person gives a guarantee upon a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the

[23](1944), Mad. 340.

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guarantee is not valid if that other person does not join (Sec. 144).

(*iii*) Where it lacks one or more essential elements of a valid contract, *e.g.*, surety is incompetent to contract or the object is illegal.

TEST QUESTIONS

1. Define a contract of indemnity. What are the rights of an indemnity-holder when sued? When does the indemnifier's liability commence?
2. What is a contract of guarantee? What are its special features? Distinguish between a contract of guarantee and a contract of indemnity.
3. Discuss the nature and extent of surety's liability.
4. What is a continuing guarantee? When and how is it revoked?
5. State the rights of a surety against *(i)* the creditor, *(ii)* the principal debtor, and (*iii*) co-sureties. Illustrate your answer.
6. (*a*) Why a surety is sometimes called a favoured debtor?
(*b*) "Between co-sureties there is equality of burden and benefit." Elucidate.
7. State and explain the circumstances under which a surety is discharged from his liability.
8. (*a*) Does the death of a surety put an end to the contract of guarantee?
(*b*) Does the release by the creditor of one of the sureties discharge the others?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* contracts to indemnify *B* against the consequences of proceedings which *C* may take against *B* in respect of a certain sum of money. *C* obtains judgment against *B* for the amount. Without paying any portion of the decree amount, *B* sues *A* for its recovery. Will *B* succeed?

[Hint. Yes, *B* will succeed because the liability of the indemnifier (*i.e.*, *A*) commences as soon as the liability of the indemnified (*i.e.*, *B*) becomes absolute.]

2. *A* is employed as a cashier on a salary of Rs 2,000 a month by a bank for a period of three years, *C* standing surety for *A's* good conduct. Nine months afterwards, when the financial position of the bank deteriorates, *A* agrees to accept a lower salary of Rs 1,500 a month. Two months later, it is discovered that *A* has been misappropriating cash all through. What is the liability of *C*?

[Hint. *C* is liable as a surety for the loss suffered by the bank due to misappropriation by *A* during the first nine months but not for misappropriations committed after the reduction in salary. (See illustration *(c)* to Sec. 133)]

3. *B* owes to *C* a debt guaranteed by *A*. The debt becomes payable. *C* does not sue *B* for a year after the debt has become payable. *B* then becomes insolvent. Thereafter *C* sues *A* for the debt. *A* pleads *C's* forbearance to sue *B* for a year as a defence. Is this a good defence?

[Hint. No, this is not a good defence and *C* must succeed. Mere forbearance on the part of the creditor to sue the principal debtor does not discharge the surety, unless otherwise agreed (Sec. 137).]

4. *A* guaranteed *Z* against trade debts to be contracted by *M* 'as a running

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balance of account to any amount not exceeding Rs 8,000'. *M* became indebted to *Z* for 10,000 rupees and made a compromise with *Z* for 60 paise in the rupee, leaving a balance of Rs 4,000 due to *Z*. *Z* brings action against *A*, claiming this amount under the guarantee. Decide?

[**Hint.** *Z* is not entitled to recover the balance of Rs 4,000 from *A* because, as per Section 135, the liability of the surety is discharged when a creditor in composition with his principal debtor accepts a lesser amount in full satisfaction of his claim.]

5. *C* advances to *D* Rs 5,000 on the guarantee of *A*. The loan carries interest at ten per cent per annum. *D* becomes financially embarrassed subsequently. On *D's* request, *C* reduces the interest to six per cent per annum and does not sue *D* for one year after the loan becomes due, *D* becomes insolvent. Can *C* sue *A*?

[**Hint.** *C* cannot sue *A*, because a surety is discharged from liability when, without his consent, the creditor makes any change in the terms of his contract with the principal debtor, no matter whether the variation is beneficial to the surety or does not materially affect the position of the surety (Sec. 133).]

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Chapter 14

Bailment and Pledge

BAILMENT

Definition

According to Section 148 of the Contract Act — "A bailment is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them."

The person delivering the goods is called the 'bailor,' the person to whom they are delivered is called the 'bailee,' and the transaction is called the 'bailment.'

A 'bailment' is thus a delivery of goods on condition that the recipient shall ultimately restore them to the bailor or dispose of them according to the directions of the bailor. Common examples of bailment are hiring of goods, furniture or a cycle, delivering of cloth to a tailor for making a suit, delivering a watch or scooter for repair, depositing goods for safe custody, *etc.*

Essential features. From the definition given by Section 148 it follows that a bailment has the following characteristic features:

1. It is a delivery of *movable goods* by one person to another person (not being his servant).

Section 149 explains the mode of delivery to the bailee and states that the delivery of goods may be either 'actual' or 'constructive.' When the bailor hands over to the bailee physical possession of the goods, that is called 'actual delivery.' 'Constructive delivery,' on the other hand, does not involve handing over the physical possession, but something is done which has the effect of putting the goods in the possession of the bailee. For example, goods in transit, *e.g.*, when they are at sea or on a railway, can be delivered by handing over the bill of lading or the railway receipt representing the goods.

2. The goods are delivered *for some purpose.* When goods are delivered by mistake without any purpose, there is no bailment within the meaning of its definition in Section 148.

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3. The goods are delivered subject to the condition that when the purpose is accomplished *the goods are to be returned in specie or disposed of* according to the directions of the bailor, either in their original form or in an altered form.

It is to be emphasised that bailment is concerned with only movable goods. Money is not included in the category of movable goods. Thus a deposit of money with a banker is not a bailment because there is no obligation to return the identical money. But if notes and coins are deposited in a box for safe custody, it is a bailment as they are to be returned in specie.

Kinds of Bailment

Bailment may be classified from the point of view of *(i)* benefit, and *(ii)* reward to the parties.

Kinds from 'benefit' point fo view. From 'benefit' point of view, bailments can be grouped into three classes;

1. *Bailment for the exclusive benefit of the bailor, e.g.,* bailor leaves goods in the safe custody of the bailee without any compensation to be paid.

2. *Bailment for the exclusive benefit of the bailee, e.g.,* a loan of some article. Thus where *A* borrows *B*'s fountain pen to use in the examination hall, the bailment is for the sole benefit of *A*, the bailee.

3. *Bailment for the mutual benefit of the bailor and the bailee.* It is the most common type of bailment. Contracts for repair, hire, *etc.,* fall within this class, wherein the bailor receives the benefit of service and the bailee benefits by the receipt of the agreed charges.

Kinds from 'reward' point of view. Bailments may also be classified on the basis of 'reward' into:

1. *Gratuitous bailment.* It is one in which neither the bailor nor the bailee is entitled to any remuneration, *e.g.*, loan of a book to a friend, depositing of goods for safe custody without any charge.

2. *Non-gratuitous bailment.* It is also called as a 'bailment for reward.' Here, either the bailor or the bailee is entitled to a remuneration, *e.g.,* motor car let out for hire, cloth given for tailoring for charges.

Consideration in Relation to Gratuitous Bailments

There arises a necessity of discovering a consideration to support a contract of bailment where it is 'for the exclusive benefit of the bailor' or 'for the exclusive benefit of the bailee,' that is, where it is a gratuitous bailment. Perhaps viewing such a transaction as a whole very carefully shall enable us to see how the doctrine of consideration is satisfied. "The detriment suffered by the bailor in parting with the possession of the goods is

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sufficient consideration to support the promise on the part of the bailee to return the goods."

Difference between 'Sale' and 'Bailment'

In the case of a 'sale' the ownership is transferred to the buyer and the buyer is under no obligation to return the goods, but in the case of a 'bailment' the ownership in goods is not transferred to the bailee and he is bound to return the goods in specie.

The *explanation* to Section 148 points out that 'if a person already in possession of the goods of another, contracts to hold them as a bailee, he thereby becomes the bailee, and the owner (*i.e.*,the buyer) becomes the bailor although such goods may not have been delivered by way of bailment." Thus, where *A* sells a cycle to *B* but *B* leaves it in *A*'s possession till he completes his other shopping, *A* becomes a bailee although originally he was the owner.

Difference between 'Bailment' and 'License'

A contract of 'license' is that under which one party is permitted to place his goods in the premises belonging to the other party.

It is to be noted that in a contract of license, there is no delivery of goods to the licenser. The licenser merely permits the licensee to use the licenser's place for keeping the licensee's goods. Thus, in a contract of license the goods are not delivered to the licenser, while in bailment the goods are delivered to the bailee and the bailee is responsible for their safety.

ILLUSTRATION. *A* went to see a horse race. He parked his car in a field belonging to a farmer, who gave a ticket to him. After the race was over, *A* returned to the field and found that the car had been stolen. *A* filed a suit against the farmer. In defence the farmer argued that he was not the bailee of the car and therefore he was under no obligation to look after the safety of the car. He had merely permitted *A* to use his field for parking the car. It was held, that this was a contract of license and not of bailment and the farmer was under no obligation to look after *A*'s car. The car had not been delivered to the farmer, as such he was not liable for any damage or penalty. (Of course the licenser should not be a party to the theft *i.e.*, he should not cooperate with the thieves).

Duties of Bailee

A bailee is the person to whom the goods are delivered. His duties are as follows:

1. **Duty to take reasonable care of goods delivered to him.** Section 151 lays down this duty, thus, "In all cases of bailment the bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence would, under similar circumstances, take of his own goods of the

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same bulk, quality and value as the goods bailed." In other words the bailee must take *reasonable care* of goods — namely the care which an average prudent man can be expected to take care of his own goods in similar circumstances.

The bailee is not an insurer of goods bailed to him. If in spite of reasonable care, the goods are lost or destroyed or deteriorated, without any negligence on his part, he is not liable in respect of any damage to the goods. It is open to parties to increase or decrease the obligations of the bailee in the matter of care by special contract. In the absence of any special contract, the standard of reasonable care will apply (Sec. 152). Even where the liability of the bailee is increased so as to keep the goods safe from thefts or accidents, he will not be liable for loss caused by State enemies or, by an act of God *e.g.*, fire, lightning, flood, *etc.*, or by communal riots (*Sunder* vs *Ram Swarup*[1]).

It is important to note that under this duty of reasonable care, the bailee is also bound to take reasonable steps to recover the goods if they have been stolen. Thus, where some goods were stolen from the bailee's custody without his fault, but he made no efforts whether by informing the owner or the police to recover them, he was held liable (*Coldman* vs *Hill*[2]). Also note that the degree of care required from the bailee is the same whether the bailment is gratuitous or for reward.

2. **Duty not to make unauthorised use of goods entrusted to him** (Sec. 154). It is the duty of the bailee to use the goods strictly in accordance with the terms of the bailment. If he makes an unauthorised use of the goods, he is liable to make compensation to the bailor for any damage arising to the goods from or during such use of them. This liability is absolute. It arises even if the bailee is not guilty of any negligence, or the damage is the result of an act of God or inevitable accident. In addition, as per Section 153, the bailor can also terminate the bailment if the bailee makes an unauthorised use of goods.

ILLUSTRATIONS. (*a*) *A* hired a horse for the purpose of riding to the Exhibition ground. On the Exhibition ground the horse was frightened by the crowd and ran into a ditch and injured itself. The bailee (*i.e.*, *A*) of the horse was not to be blamed for accident. He is not liable for the injury to the horse.

(*b*) *A* hired a horse for the purpose of riding to the Exhibition ground. But later on he went riding in a different direction in violation of the contract. During the ride the horse became frightened and ran into a ditch and injured itself. *A*, the hirer, was not to be blamed for the accident, but he is liable to the bailor for the injury to the horse, because he made an unauthorised use of the horse.

(*c*) *A* lends a horse to *B* for his own riding only. *B* allows *C*, a member of his family, to ride the horse. *C* rides with care, but the horse accidently falls and is

[1](1952), All. 205.
[2](1919), 1 K.B. 443.

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injured. *B* is liable to make compensation to *A* for the injury done to the horse. [Illustration *(a)* to Section 154]

(*d*) A goldsmith accompanied by his wife went from his village to another village to attend a marriage. The goldsmith took with him some ornaments entrusted to his care by customers. The object was to enable his wife to wear the ornaments at the marriage. On the way a gang of robbers attacked them and took away all their goods including the ornaments. The goldsmith was held liable to the customers for the price of ornaments because he had made an unauthorised use of the goods entrusted to his care.

3. **Duty not to mix goods bailed with his own goods.** It is also the duty of a bailee that he should not mix his own goods with those of the bailor, without bailor's consent. If the goods are mixed with the consent of the bailor, there is no breach of duty and the bailor and the bailee shall have an interest, in proportion to their respective shares, in the mixture thus produced (Sec. 155). But if the bailee, without the consent of the bailor, mixes up his own goods with those of the bailor, whether intentionally or accidentally, the following rules apply:

(*a*) Where the goods can be separated or divided, the property in the goods remains in the parties respectively, but the bailee is bound to bear the expenses of separation as well as any damage arising from the mixture (Sec. 156).

ILLUSTRATION (to Sec. 156). *A* bails 100 bales of cotton marked with a particular mark to *B*. *B*, without *A*'s consent, mixes the 100 bales with other bales of his own, bearing a different mark. *A* is entitled to have his 100 bales returned, and *B* is bound to bear all the expenses incurred in the separation of the bales, and any other incidental damage.

(*b*) Where the goods mixed cannot be separated, the bailee must compensate the bailor for his loss (Sec. 157).

ILLUSTRATION (to Sec. 157). *A* bails a barrel of Cape flour worth Rs 45 to *B*. *B*, without *A*'s consent mixes the flour with country flour of his own, worth only Rs 25 a barrel. *B* must compensate *A* for the loss of his flour.

4. **Duty to return the goods.** Section 160 lays down this duty in the following terms: "It is the duty of the bailee to return, or deliver, according to the bailor's directions the goods bailed, without demand, as soon as the time for which they were bailed has expired, or the purpose for which they were bailed has been accomplished." Where there are several joint bailors, the bailee may return the goods to any one of the joint owners (Sec. 165).

When the bailee fails to return the goods at the proper time, he becomes responsible to the bailor for any loss, destruction or deterioration of the goods from that time (Sec. 161). It is important to note that if the goods are not returned at proper time, the bailee is liable for the loss occurring thereafter even without his negligence, *i.e.*, by an act of God. Of course, this is in addition to the bailee's liability for ordinary damages for breach of contract of bailment.

ILLUSTRATION. *A* hires a horse from *B* for one week. But *A* defaults in

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returning the horse on the due date. The horse dies one day after the expiry of the period of bailment without any fault on *A*'s part. *A* is liable for the price of the horse to *B*, along with damages for the delay. (If the horse dies within one week, *i.e.*, before the expiry of the period of bailment without *A*'s negligence, *A* is not liable for the price.)

5. **Duty to deliver any accretion to the goods** (Sec. 163). It is the duty of the bailee to deliver to the bailor any natural increase or profit accruing from the goods bailed, unless there is a contract to the contrary.

ILLUSTRATION (appended to Sec. 163). *A* leaves a cow in the custody of *B* to be taken care of. The cow has a calf. *B* is bound to deliver the calf as well as the cow to *A*.

Duties of Bailor

A bailor is the person who delivers the goods. His duties are as follows:

1. **Duty to disclose faults in goods bailed.** Section 150 lays down this duty. The Section makes a distinction between a gratuitous bailor and a bailor for reward and provides as follows:

(a) A gratuitous bailor is bound to disclose to the bailee all those faults in the goods bailed, *of which he is aware* and which materially interfere with the use of them, or expose the bailee to extraordinary risks, and if he fails to do so, he will be liable to pay such damages to the bailee as may have resulted directly from the faults. A gratuitous bailor will not be liable for damages arising to the bailee from defects of which he was ignorant.

ILLUSTRATION (to Sec. 150). *A* lends a horse, which he knows to be vicious, to *B*. He does not disclose the fact that the horse is vicious. The horse runs away. *B* is thrown and injured. *A* is responsible to *B* for damage sustained.

(*b*) A bailor for reward is responsible *for all defects* in the goods bailed whether he is aware of the defects or not, if he does not disclose them to the bailee. Unlike a gratuitous bailor, ignorance of the defects is no defence for him.

ILLUSTRATION (to Sec. 150). *A* hires a carriage of *B*. The carriage is unsafe though *B* is not aware of it, and *A* is injured. *B* is responsible to *A* for the injury. (If the carriage were lent gratuitously, *B* would not be liable under the circumstances. Similarly, had *B* told the fault to *A*, then also he would not be liable.)

It may be mentioned that where the goods bailed are of dangerous nature, it is the duty of the bailor to disclose the fact to the bailee otherwise he will be liable for all the resulting damage (*Great Northern Rly.* vs *L.E.P. Transport Ltd.*[3]). For example, *A* delivers to *B* , a carrier, some explosives in a case but does not warn *B*. The case is handled without extra care necessary for such articles and there is an explosion. The carrier is injured and some other goods are damaged. *A*, the bailor, is liable for all the resulting damage.

2. **Duty to repay necessary expenses in case of gratuitous bailment**

[3](1922), 2 K.B. 742.

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(Sec. 158). Where, by the conditions of the bailment, the goods are to be kept or to be carried or to have work done upon them by the bailee for the bailor, and the bailee is to receive no remuneration, it is the duty of the bailor to repay all the necessary expenses incurred by the bailee for the purpose of the bailment. Thus where a horse is bailed without reward for safe custody, it is the duty of the bailor to reimburse the bailee for usual feeding expenses of the horse as well as for the medical expenses, if any.

3. **Duty to repay any 'extraordinary' expenses in case of non-gratuitous bailment.** Where under the terms of the bailment, the bailee is to receive remuneration for his services, it is the duty of the bailor to bear *extraordinary expenses,* if any, incurred by the bailee in relation to the thing bailed. In such a bailment the bailor is not to bear the ordinary or usual expenses. Thus where a horse is bailed for safe custody and the bailee is to receive Rs 80 per day as custody charges, the bailor is not liable to repay the bailee the ordinary expenses of feeding the horse. But if during the bailee's custody the horse falls ill without any negligence on his part, the bailor must repay the bailee the medical expenses incurred in connection with the treatment of the horse, these being extraordinary expenses.

4. **Duty to indemnify bailee** (Sec. 164). A bailor is also bound to indemnify the bailee for any loss suffered by the bailee, by reason of the fact that the bailor was not entitled to bail the goods because of the defective title.

ILLUSTRATION. *A* gives his neighbour's scooter to *B* for use without the neighbour's permission. The neighbour sues *B* and receives compensation. *A* is bound to indemnify *B* for his losses.

5. **Duty to receive back the goods.** It is the duty of the bailor to receive back the goods when the bailee returns them after the time of bailment has expired or the purpose of bailment has been accomplished. If the bailor refuses to take delivery of goods when it is offered at the proper time, the bailee can claim compensation for all necessary expenses of, and incidental to, the safe custody.

Rights of Bailee

1. **Enforcement of bailor's duties.** The duties of the bailor are the rights of the bailee. As such, the bailee can, by suit, enforce the duties of the bailor enumerated above. To recapitulate, the bailee has the following rights against the bailor (based on the bailor's duties discussed above):

(*i*) Right to claim damages for loss arising from the undisclosed faults in the goods bailed (Sec. 150).

(*ii*) Right to claim reimbursement for extraordinary expenses incurred in relation to the thing bailed (Sec. 158).

(*iii*) Right to indemnity for any loss suffered by him by reason of

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defective title of the bailor to the goods bailed (Sec. 164).

(*iv*) Right to claim compensation for expenses incurred for the safe custody of the goods if the bailor has wrongfully refused to take delivery of them after the term of bailment is over.

2. **Right to deliver goods to one of several joint bailors** (Sec. 165). Where goods have been bailed by several joint owners, the bailee has a right to deliver them to, or according to the directions of, one joint owner without the consent of all, in the absence of any agreement to the contrary.

3. **Right to deliver goods, in good faith, to bailor without title** (Sec. 166). The bailee has a right to deliver the goods, in good faith, to the bailor without title, without incurring any liability towards the true owner.

4. **Right of lien.** The right to retain possession of the property or goods belonging to another until some debt or claim is paid, is called the right of lien. The right depends on possession and is lost as soon as possession of the goods is lost. As such it is also called as 'possessory lien.' Liens may be of two types— 'particular' and 'general.'

'Particular lien' means the right to retain only that particular property in respect of which the charge is due. 'General lien' means the right to retain all the goods of the other party until all the claims of the holder against the party are satisfied. In other words, this is a right to retain the goods of another as a security for a general balance of account.

Bailee's particular lien. Section 170 confers the right of particular lien upon a bailee and provides that "where the bailee has, in accordance with the purpose of the bailment, rendered any service involving the exercise of labour or skill in respect of the goods bailed, he has, in the absence of a contract to the contrary, a right to retain such goods until he receives due remuneration for the services he has rendered in respect of them.

Thus a bailee has a particular lien when the following conditions are fulfilled:

(*i*) The bailee must have rendered some service in relation to the thing bailed and must be entitled to some remuneration for it, which must not have been paid.

(*ii*) The service rendered by the bailee must be one involving the exercise of labour or skill in respect of the goods bailed, *so as to confer an additional value on the article.*

ILLUSTRATION [*(a)* appended to Sec. 170]. *A*, delivers a rough diamond to *B*, a jeweller, to be cut and polished which is accordingly done. *B* is entitled to retain the stone till he is paid for the services he has rendered. (Jeweller's labour and skill must have enhanced the value of the stone.)

It is to be emphasised that there is no lien if the labour and skill exercised by the bailee does not improve the value of the goods bailed. Thus a person who takes a horse for feeding and keeping at his stable has no lien for his charges because no additional value has been added to the

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horse by his labour (*Hutton* vs *Car Maintenance Co.*[4]). Similarly, there is no lien for safe custody charges because there is no exercise of labour or skill (*Vithoba* vs *Maruthi*[5]). In such cases the bailee can only sue the bailor for the charges due.

(*iii*) The services must have been performed *in full* in accordance with the directions of the bailor, within the agreed time or a reasonable time.

ILLUSTRATION. *A* gives his watch to *B* for repair. *B* promises *A* to deliver the watch on the third day. But *B* takes one week to repair it. *B* is not entitled to retain the watch until he is paid.

(*iv*) There must not be an agreement to perform the service on credit.

ILLUSTRATION [*(b)* appended to Sec. 170]. *A* gives cloth to *B*, a tailor, to make into a coat. *B* promises *A* to deliver the coat as soon as it is finished, and to give a three months' credit for the price. *B* is not entitled to retain the coat until he is paid.

(*v*) The goods must be in possession of the bailee. If possession is lost, the lien is also lost.

(*iv*) There must not be a contract to the contrary.

If all the above mentioned conditions are satisfied, the bailee can exercise his right of particular lien until he is paid for his services.

The following points must also be noted in connection with the bailee's particular lien:

(*a*) The bailee retaining the article to enforce his lien cannot charge for keeping it.

(*b*) The bailee cannot exercise his lien for the non-payment of extraordinary expenses incurred in relation to the thing bailed. He should sue for them.

Besides the bailee, other persons who are entitled to exercise the right of particular lien are: finder of goods (Sec. 168), pawnee (Secs. 173-174), agent (Sec. 221), and unpaid seller (Sec. 47 of the Sale of Goods Act).

Bailee's general lien. As observed earlier, a general lien is a right to retain the goods of another as a security for a general balance of account. In simple words, this right entitles a person to retain possession of any goods belonging to another for any amount due to him whether in respect of those goods or any other goods. For example, if two loans have been taken against two securities from a banker and the borrower repays one of these loans, the banker may detain both securities until his other loan is paid.

According to Section 171, bailees coming within the following categories have a 'general lien,' in the absence of a contract to the contrary:

(*i*) *Bankers.* A banker has a general lien on all goods, cash, cheques and securities deposited with him as banker by a customer, for any money due

[4](1915), 1 Ch. 621.
[5]A.I.R. (1940) Nag. 273.

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to his as a banker. Thus, where a customer has a credit balance in one account of the bank and at the same time he owes money to the bank on another account, the banker's general lien entitles him to refuse the customer to operate the account in which he has a credit balance till he clears the debt due to the bank (*Davendra Kumar* vs *Chaudhary Gulab Singh*[6]). But where valuables and securities are deposited for a specific purpose, *e.g.*, for safe custody, the banker has no general lien on them as the acceptance of the goods for a special purpose impliedly excludes general lien (*Cuthbert* vs *Robarts*[7]).

(*ii*) *Factors.* A factor is an agent entrusted with the possession of goods in the ordinary course of his business for the purpose of sale. He has a general lien on the goods of his principal, if any money is due to him by his principal whether for advances made or for remuneration.

(*iii*) *Wharfingers.* A wharfinger has a general lien on the goods as regards charges due for the use of wharf against the owner of the goods.

(*iv*) *Attorneys of High Court.* An attorney or solicitor of a High Court has a general lien on all papers and documents belonging to his client which are in his possession in his professional capacity until the fee for his professional service and other cost incurred by him are paid. But if the solicitor refuses to act any more for the client, he is not entitled to any lien.

(*v*) *Policy brokers.* They can retain the policy of fire or marine insurance for their brokerage.

(*vi*) Any other person, if there is an express contract to that effect.

Rights of Bailor

1. **Enforcement of bailee's duties.** The duties of the bailee are the rights of the bailor. The bailor can enforce by suit all the duties of the bailee (already discussed) as his rights. To recapitulate, the bailor has the following rights against the bailee (based on the bailee's duties discussed earlier):

(*i*) Right to claim damages for loss caused to the goods bailed by bailee's negligence (Sec. 151).

(*ii*) Right to claim compensation for any damage arising from or during unauthorised use of the goods bailed (Sec. 154).

(*iii*) Right to claim compensation for any loss caused by the unauthorised mixing of goods bailed with his own goods (Secs. 155-156).

(*iv*) Right to demand return of goods as soon as the time for which they were bailed has expired, or the purpose for which they were bailed has been accomplished (Sec. 160).

(*v*) Right to claim any natural accretion to the goods bailed (Sec. 163).

2. **Right to terminate bailment if the bailee uses the goods wrongfully** (Sec. 153). The bailor has a right to terminate the bailment, if the

[6]I.L.R. (1946), Nag. 210.
[7](1909), 2 Ch. 226.

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bailee does, with regard to the goods bailed, any act which is inconsistent with the terms of the bailment, although the term of bailment has not expired or the purpose of bailment has not been accomplished.

ILLUSTRATION (to Sec. 153). *A* gives on hire to *B* a horse for his own riding. *B* drives the horse in his carriage. The contract of bailment is voidable at the option of *A*.

3. **Right to demand return of goods at any time in case of gratuitous bailment** (Sec. 159). When the goods are lent without reward (*i.e.*, gratuitously), the bailor can demand their return whenever he pleases even though he lent them for a specified purpose or time and the bailee is not guilty of wrongful use. But if the premature return of goods causes the bailee loss in excess of benefit actually derived by him from the use of such goods, the bailor must indemnify the bailee for the amount in which the loss occasioned exceeds the benefit derived.

Rights of Bailors and Bailees against Wrong-doers

If a third person wrongfully deprives the bailee of the use or possession of the goods bailed, or does them any injury, the bailee is entitled to use such remedies as the owner might have used in the like case if no bailment had been made; and either the bailor or the bailee may bring a suit against the wrong-doer for such deprivation or injury (Sec. 180). Whatever is obtained by way of relief or compensation in any such suit, is to be apportioned, as between the bailor and the bailee, according to their respective interests (Sec. 181). For example, if somebody forcefully takes possession of a coat from a tailor's shop, then either the tailor or the owner of the coat may sue the wrong-doer. If the tailor files the suit, he shall hand over the recovered amount, after deducting his tailoring charges, to the owner of the coat.

Termination of Bailment

A contract of bailment terminates under the following circumstances:

1. If the bailment is for a 'specified period,' the bailment terminates as soon as the stipulated period expires.

2. If the bailment is for a 'specific purpose,' the bailment terminates as soon as the purpose is fulfilled.

3. If the bailee does any act with regard to the goods bailed, which is inconsistent with the terms of bailment, the bailment may be terminated by the bailor even though the term of bailment has not expired or the purpose of bailment has not been accomplished (Sec. 153).

4. A gratuitous bailment can be terminated by the bailor at any time, even before the specified time or before the purpose is achieved, subject to the limitation that where such termination causes loss in excess of benefit actually derived by the bailee, the bailor must indemnify the bailee for the

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amount in which the loss occasioned exceeds the benefit derived (Sec. 159).

5. A gratuitous bailment is terminated by the death either of the bailor or of the bailee (Sec. 162).

FINDER OF LOST GOODS

A finder of lost goods is under no obligation to take charge of the goods when he comes across. But if he does take the charge of the goods, he becomes responsible for the goods like a bailee in a gratuitous bailment. Section 71 clearly provides to this effect, thus, "a person who finds goods belonging to another and takes them into his custody, is subject to the same responsibility as a bailee."

Duties of Finder

The more important duties of a finder of goods are as follows:[8]

1. **Duty to find the true owner.** It is the duty of the finder to make reasonable efforts to find the true owner of the goods. For example, if one finds goods of little value at a public place, he should shout three times in search of the true owner, and if the goods found are valuable proper advertisement in newspapers *etc.*, should be given. If the finder fails in this duty, he will be liable as a trespasser or a thief.

2. **Duty to take reasonable care of the goods as a bailee.** A finder must take as much care of the goods as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same description. If in spite of reasonable care, the goods are lost or destroyed, he is not liable for any loss.

Rights of Finder

The rights of a finder of goods are as follows:

1. **Right to retain possession of the goods until the true owner is found.** A finder has the right to retain possession of the goods against the whole world, except the true owner. It is important that the finder never becomes the owner of the goods. The ownership will always remain with the true owner, and the finder only enjoys the right to retain possession against everybody except the true owner. If anybody deprives him of the possession of the goods, he can maintain an action for trespass.

2. **Right of lien over the goods for expenses** (Sec. 168). A finder has a right to retain the goods against the true owner until he receives reasonable compensation for trouble and expense incurred by him to preserve the

[8]For a detailed account of duties, please refer to—"*Duties of Bailee*" discussed earlier in the present chapter.

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goods and to find out the true owner. But he has no right to file a suit against the owner to recover expenses incurred by him because there is no contract between him and the true owner. He incurred the expenses voluntarily and not at the request of the true owner.

3. **Right to sue for reward** (Sec. 168). The finder can file a suit against the true owner to recover any reward, which was offered by the true owner for the return of the goods lost, provided he came to know of the offer before actually finding out the goods. He may also retain the goods until he receives the reward.

4. **Right of sale** (Sec. 169). If the true owner cannot be found with reasonable diligence, or if he refuses, upon demand, to pay the lawful charges of the finder, the finder may sell the goods in the following cases:

(*a*) when the thing is in danger of perishing or of losing the greater part of its value, or

(*b*) when the lawful charges of the finder, in respect of the thing found, amount to two-third of its value.

The true owner, however, is entitled to get the balance of sale proceeds, if there is a surplus left after meeting the lawful charges of the finder

ILLUSTRATION. *A* finds a lost horse. After a diligent search *A* discovers the true owner and offers to return the horse to him, on condition that the true owner pays *A*'s lawful expenses amounting to Rs 150. The true owner refuses to pay. *A* cannot file a suit for the recovery of the expenses in the absence of privity of contract. He cannot also sell the horse until his lawful charges amount to two-third of the value of the horse.

PLEDGE OR PAWN

Definition

"The bailment of goods as security for payment of a debt or performance of a promise is called 'pledge'. The bailor in this case is called the 'pawnor.' The bailee is called the 'pawnee' (Sec. 172).

ILLUSTRATION. *A* borrows Rs 100 from *B* and keeps his watch as security for payment of the debt. The bailment of watch is called a pledge.

Thus a pledge is only a special kind of bailment. Here goods are deposited with a lender or promisee as security for the repayment of a loan or performance of a promise. Otherwise, like bailment, a pledge also involves only a transfer of possession of goods pledged. The ownership remains with the pledgor. The pledgee or pawnee has only a special interest in the goods pledged. The general interest remains in the pawnor and wholly reverts to him on discharge of the debt. Further, like bailment, a pledge is concerned with only movable goods, The movable goods include any kind of goods, valuables and documents of title *e.g.*, railway receipt,

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bill of lading, etc. (*Morvi Mercantile Bank* vs *Union of India*[9]). Even a savings bank pass book issued by post office (which must accompany any withdrawal) may be pledged (*J. & K. Bank* vs *Tek Chand*[10]).

Distinction between Bailment and Pledge

1. *As to purpose.* Pledge is the bailment of goods for a specific purpose *i.e.*, to provide a security for a loan or for the fulfilment of an obligation, whereas there is no such purpose in case of bailment. A bailment is for a purpose other than the above two, *e.g.*, for repairs, safe custody, etc.

2. *As to right of sale.* In case of pledge, the pledgee has a right of sale (of the goods pledged) on default after giving notice to the pledgor but there is no such right of sale to the bailee in case of bailment. The bailee may either retain the goods or sue the bailor for non-payment of his dues.

3. *As to right of using the goods.* In case of pledge, the pledgee has no right of using the goods pledged, while no such restriction, exists for a bailee in case of bailment if the nature of transaction so requires.

Rights of Pawnee

1. **Right of retainer** (Sec. 173). The pawnee has the right to retain the goods pledged until his dues are paid. He has the right to retain the goods pledged, not only for payment of the debt or performance of the promise, but for the interest due on the debt and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged. Thus this right may be termed as the pawnee's right of 'particular lien.'

2. **Right of retainer for subsequent advances** (Sec. 174). When the pawnee lends money to the same debtor after the date of the pledge without any further security, it shall be presumed that the right of retainer over the pledged goods extends even to subsequent advances. This presumption can be rebutted only by a contract to the contrary. It will be noticed that although a pawnee has a 'particular lien' only, but this Section allows him to track his subsequent advances to the original debt in the absence of any agreement to the contrary.

3. **Right to extraordinary expenses** (Sec. 175). The pawnee also has the right to recover from the pawnor extraordinary expenses incurred by him for the preservation of the goods pledged. But he cannot retain the goods, if such expenses are not paid. He has only a right to sue the pawnee for recovery of such extraordinary expenses.

4. **Right to sue the pawnor or sell the goods on default of the**

[9]A.I.R. (1965), S.C. 1954.
[10]A.I.R. (1959) J & K. 67.

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pawnor (Sec. 176). Where a pawnor makes default in the payment of the debt or performance of the promise, the pawnee may exercise either of the following rights:

(*a*) He may bring a suit against the pawnor for the recovery of the amount due to him and retain the goods pledged as a collateral security; or

(*b*) He may himself sell the thing pledged, after giving to the pawnor a reasonable notice of his intention to sell.

In connection with the alternative right of sale, the following points must be noted:

(*i*) The requirement of a 'reasonable notice' is a statutory obligation and cannot be waived by agreement. A sale without notice is void, notwithstanding any contract to the contrary.

(*ii*) The pawnee cannot sell the goods to himself and if he does so then such a sale is void as against the pawnor and the pawnor can recover the goods on paying the amount due.

(*iii*) If the proceeds of such sale are insufficient to meet the full claim of the pawnee, he may recover the balance from the pawnor, but if there is surplus, he must pay it over to the pawnor.

Duties of Pawnee

Pledge being a special kind of bailment, the duties of a pawnee are just like a bailee.[11] Thus a pawnee's duties may be enumerated as follows:

1. To take reasonable care of the goods pledged.
2. Not to make any unauthorised use of the goods pledged.
3. Not to mix the goods pledged with his own goods.
4. Not to do any act in violation of the terms of the contract of pledge and of the provisions of the Contract Act. For example, he should not sell the goods pledged without a reasonable notice to the pawnor.
5. To return the goods pledged on receipt of his full dues.
6. To deliver any accretion to the goods pledged *e.g.*, bonus shares must also be delivered where shares from the subject-matter of pledge. The accretion remains the property of the pawnor (*M.R. Dhawan* vs *Madan Mohan*[12]).

Rights of Pawnor

1. **Enforcement of pawnee's duties.** The duties of the pawnee are the rights of the pawnor. The pawnor can, therefore, enforce by suit all the duties of the pawnee(enumerated above) as his rights. For example, if the pawnee makes an unauthorised sale (without giving the notice as required

[11]The '*duties of a bailee*' have been discussed in detail earlier in this chapter.
[12]A.I.R. (1969), Del. 313.

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under Section 176), the pawnor can file a suit for redemption of goods, treating the sale as void (of course after depositing with the Court the full amount due), or for damages for conversion. Similarly, the pawnor has a right to receive the pledged goods back along with accretion, if any, on making the payment on stipulated date, and so forth.

2. **Defaulting pawnor's right to redeem** (Sec. 177). A pawnor, who defaults in payment of the debt amount at the stipulated date, has a right to redeem the debt at any subsequent time before the actual sale of goods pledged. Thus an agreement that the pledge should become irredeemable, if it is not redeemed within a certain time, would be invalid. Of course, the pawnor redeeming after the expiry of the specified time must pay to the pawnee, in addition, any expenses which have arisen from his default.

Duties of Pawnor

The more important duties of a pawnor are as follows:

1. To compensate the pawnee for any extraordinary expenses incurred by him (Sec. 175)

2. To meet his obligation on stipulated date and comply with the terms of contract.

Pledge by Non-owners

The owner of goods can always make a valid pledge, but in the following cases pledge made by non-owners will also be valid:

1. **Mercantile agents** (Sec. 178). A mercantile agent means an agent having in the customary course of business as such agent authority either to sell goods, or to consign goods for the purpose of sale, or to buy goods, or to raise money on the security of goods [Sec. 2(9) of the Sale of Goods Act].

A mercantile agent who is, with the consent of the owner, in possession of the goods or the documents of title to goods (*e.g.*,railway receipt or bill of lading), can make a valid pledge of the goods while acting in the ordinary course of business of a mercantile agent. Such a pledge will be valid even if the agent had no actual authority to pledge, provided that the pawnee acts in good faith and has not at the time of the pledge any notice that the pawnor has no authority to pledge (Sec. 178).

It must be noted that a person in bare possession of goods cannot make a valid pledge. For example, a servant to whom goods are entrusted by his master during his (master's) absence cannot make a valid pledge. Similarly, a person entrusted with goods for a specific purpose cannot pledge the goods, *e.g.*, goods held for safe custody or under a contract of hire cannot be pledged.

2. **Person in possession under voidable contract** (Sec. 178-A). A

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person having possession of goods under a voidable contract can make a valid pledge of the goods, provided the contract has not been rescinded at the time of the pledge and the pledgee has acted in good faith and without notice of the pledgor's defect of title. For example, where *A* purchases a ring from *B* by exercising coercion and pawns it with *C* before the contract is rescinded by *B*, the pledge is valid. *C* will get a good title to the ring and *B* can only claim damages from *A*.

3. **Pledgor having limited interest** (Sec. 179). Where a person pledges goods in which he has only a limited interest, the pledge is valid to the extent of that interest. Thus, a person having a lien over the goods may pledge them to the extent of his interest. For example, *A* delivers a suit length to *B*, the tailor master, for making a suit and agrees to pay Rs 1,500 as sewing charges. *B* pledges the suit with *C* for Rs 3,000. The pledge is valid to the extent of *B's* interest in the suit, namely, Rs 1,500 (sewing charges). *A* can, therefore, recover the suit only on paying Rs 1,500 to *C*, the pledgee.

4. **Seller in possession of goods after sale** [Sec. 30 (1) of the Sale of Goods Act]. A seller, left in possession of goods sold, is no more owner of the goods, but a pledge created by him will be valid, provided the pawnee acted in good faith and had no notice of the sale of goods to the buyer. The original buyer can obtain damages from the seller but cannot recover the goods from the pledgee.

5. **Buyer in possession of goods under an "agreement to sell"** [Sec. 30(2) of the Sale of Goods Act]. Where a buyer under an 'agreement to sell', wherein the goods to become the property of the buyer on fulfilment of certain condition or on expiry of some time, obtains possession of goods with the seller's consent before the payment of price and pledges them, the pledge is valid, provided the pledgee acted in good faith and had no notice of the pledgor's defect in title of the goods pledged. It may be mentioned that under an 'agreement to sell' the ownership remains with the seller until the 'agreement to sell' becomes a 'sale' by the fulfilment of agreed condition.

ILLUSTRATION. *A* agrees to buy a car if his solicitor approves and obtains possession of the car and pledges it. The pledge is valid, although at the time of pledge *A* was not the owner and later on also he does not become owner as the solicitor disapproves the purchase.

6. **Co-owner in possession.** Where there are several joint owners of goods, one of the co-owners in sole possession thereof with the consent of other co-owners may make a valid pledge of the goods.

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TEST QUESTIONS

1. Define a bailment and briefly state the rights and duties of bailor and bailee.
2. Define bailment and give its characteristics. How does bailment differ from 'sale'? What is a bailee's lien?
3. Explain the nature of the bailee's particular lien. How does it differ from the general lien of bankers and factors?
4. What are the rights and obligations of a finder of goods? What is the nature of the lien which finder of goods has over the goods?
5. Define pledge and distinguish between pledge and bailment. When will a pledge made by a non-owner of the goods be valid?
6. Define pledge, and state the respective rights and duties of pawnor and pawnee.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* gives some cloth to a tailor for making a suit of it. The tailor's charges are settled at Rs 1,000. After the suit is ready *A* tenders Rs 1,000 for the charges but the tailor refuses to deliver the suit till *A* pays an old debt of Rs 200. Is the tailor entitled to do so?

[**Hint**. The tailor is not entitled to refuse to deliver the suit for the old debt of Rs 200, because a bailee, who renders a service involving the exercise of labour or skill in respect of the goods bailed, so as to confer an additional value on the article, is entitled only to a right of 'particular lien' *i.e.*, a right to retain only that particular thing in respect of which the charge is due. (Sec. 170)]

2. A lady employed a goldsmith for the purpose of melting old jewellery and making new ones. Every evening as soon as the goldsmith's work for the day was over, the lady used to receive the half made jewellery from the goldsmith and put it into a box which was left in a room in the goldsmith's house of which she retained the key. One night the box was stolen. Is the goldsmith liable to make good the loss?

[**Hint**. The goldsmith is not liable to make good the loss of jewellery because he cannot be said a bailee of the goods. The bailment must be taken to have come to an end as soon as the lady was put in possession of the half made jewellery. Again, the lady herself took away the key and therefore there was no effective delivery of the contents of the box to the goldsmith either actually or constructively. As such the goldsmith cannot be regarded as bailee thereof and cannot be made liable for the loss (*Kaliaperumal Pillai* vs *Visalakshmi*, A.I.R., 1938, Mad. 32).]

3. *A*, finds a horse which carries a reward of Rs 200 to the finder offered by *B*, the owner. *A* telegraphically informs *B* about the horse and spends Rs 15 thereon. *B* comes to take the horse after two days and during the intervening period *A* spent Rs 80 on feeding the horse. *A* returns the horse to *B* without insisting prepayment of his lawful charges of Rs 95 and the amount of reward. Subsequently *B* refuses to pay. *A* files a suit against *B* for the recovery of Rs 295. Will he succeed?

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[**Hint.** *A* will succeed only for the recovery of the amount of reward *i.e.*, Rs 200 because here there is a contract between *A* and *B*. *B*, while offering the reward, made a general offer which *A* accepted by returning the horse. But *A* cannot recover the amount of expenses *i.e.*, Rs 95 as there is no contract between the two in that regard. *A* also cannot exercise the right of lien as possession has been lost (Sec. 168).]

4. *A* pledges with *B* jewels worth Rs 60,000 and borrows Rs 30,000 at 12 percent interest per annum, promising to repay the amount and redeem the jewels within a year. *B*, having apprehension about the safety of the jewels, because of increasing burglaries in the town, not only insures the jewels but also buys a strong safe at a cost of Rs 800, there being no safety vault in that town and keeps the jewels in that safe. Now, when *A* comes to repay the loan, *B* claims the amount due for principal and interest, cost of insurance and cost of the safe. But *A* admits liability only for the principal and interest. Decide?

[**Hint.** *B* is entitled to recover from *A* the amount of the principal and the interest plus the cost of insurance and of the safe. There is no dispute so far as the amount of principal and interest is concerned. As regards cost of insurance and of the safe, it should be noted that under Section 175, *B*, the pawnee, is entitled to these expenses also as they have been incurred for the preservation of the goods pawned and are such which any person of ordinary prudence would reasonably incur in the given circumstances.]

5. *B* handed her jewellery to *M* to value it and tell her what advance he could make on them, it being agreed that *M* was to keep the jewellery as security if he made the advance. On the same day *M* pledged the jewellery with *A*, a pawnbroker, who advanced £1,000 in good faith. Four days later *M* advanced £500 to *B* on the security of her jewellery. Subsequently on coming to know of the transaction between *M* and *A*, *B* paid the amount she had borrowed and sued *A* for the recovery of her jewellery contending that when *M* advanced the money, no valid pledge could arise as there was no delivery of goods in pursuance of the contract of pledge and *M* had already parted with the possession of the goods by pledging them with *A*. will *B* succeed? Give reasons.

[**Hint.** No, *B* will not succeed as the pledge is valid. The facts in the instant case are similar to *Blundell* vs *Atten* (1921,3 K.B. 233). In that case it was held that the pledge was valid. Delivery made four days before was a good delivery for the purpose of creating a pledge, whenever that pledge was created. "Delivery of possession and advance need not be simultaneous and a pledge may be perfected by delivery before or after the advance is made" (*Lallan Prasad* vs *Rahmat Ali*, A.I.R. 1967, SC, 1322).] *B* would have succeeded had she made the payment of £500 along with interest to *A* instead of *M* because the pledge in between *M* and *A* was valid only to the extent of *M*'s interest in the jewellery, namely, £500 (amount of advance to *B*). Of course, on making the payment to *M*, *B* has a right to sue *M* for the redemption of her jewellery.]

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Chapter 15

Agency

Definitions of Agent and Principal

The two terms—'agent' and 'principal'—have been defined in Section 182 of the Contract Act as follows:

"An *agent* is a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done, or who is represented, is called the *principal.*"

The contract which creates the relationship of 'principal' and 'agent' is called an 'agency'. Thus where *A* appoints *B* to buy ten bags of sugar on his behalf, *A* is the 'principal,' *B* is the 'agent' and the contract between the two is 'agency.' If, in pursuance of the contract of agency, the 'agent' purchases the bags of sugar from *C*, a wholesale dealer in sugar, on credit, then in the eye of law the 'principal' and the wholesale dealer are brought into direct contractual relations and the contract of purchase is enforceable both by and against the 'principal.'

It will be seen that under a contract of agency the agent is authorised to establish privity of contract between the principal (his employer) and a third party. As such the function of an agent is essentially to bring about contractual relations between the principal and third parties. In a way, therefore, an agent is merely a connecting link. After entering into a contract on behalf of the principal with a third party, the agent drops out and ceases to be a party to the contract and the contract binds the principal and the third party as if they have made it themselves.

General Rules of Agency

There are two important general rules regarding agency, *viz.*,

1. Whatever a person competent to contract may do by himself, he may do through an agent, except for acts involving personal skill and qualifications. In fact, where the work to be done is obviously personal, no agent can be employed. For example, a person cannot marry through an agent, cannot paint a picture through an agent, and so on.

2. "He who does through another, does by himself." In other words, 'the acts of the agent are, for all legal purposes, the acts of the principal.'

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Section 226 provides to the same effect: "Contracts entered into through an agent, and obligations arising from acts done by an agent, may be enforced in the same manner, and will have the same legal consequences, as if the contracts had been entered into and the acts done by the principal in person."

ILLUSTRATIONS (appended to Sec. 226). *(a) A* buys goods from *B*, knowing that he is an agent for their sale, but not knowing who is the principal. *B*'s principal is the person entitled to claim from *A* the price of the goods and *A* cannot, in a suit by the principal, set off against that claim a debt due to himself from *B*.

(b) A being *B*'s agent, with authority to receive money on his behalf, receives from *C* a sum of money due to *B*. *C* is discharged of his obligation to pay the sum in question to *B*.

Test of Agency

Agency exists 'whenever a person has the authority to act on behalf of the other and to create contractual relations between that other and third persons.' When this kind of power is not enjoyed, the relationship is not one of agency. Thus a person is not an agent merely because he gives another advice in matters of business (*Mahesh Chandra* vs *Radha Kishore*[1]). Similarly, a person rendering personal service to his master or working in his factory cannot be called an agent because in these cases he is not acting for another in dealings with third persons. It is only when one acts as a representative of the other in business dealings so as to create contractual relations between that other and third persons, that he is an agent and there is an agency (*Krishna* vs *Ganapathi*[2]).

Distinction between Agent and Servant

A servant acts under the direct control and supervision of his employer, that is, he has to act according to the orders of the master in every particular case. He does not create relations between his employer and third persons and cannot bind the master to third parties. If, for some purpose, he is authorised to bind the master, then to that extent he is an agent.

An agent is not subject to the direct control and supervision of the principal. He has often a large discretion to act within the scope of his authority. A 'principal' directs the agent "as to what is to be done" while a 'master' has the further right to direct "how the work is to be done." Thus a very minute difference exists between the two. Further, an agent is appointed to bring the principal into contractual relations with third parties.

An agent as such is not a servant but a servant is generally for some purposes his master's agent, the extent of agency depending upon the duties

[1](1908), 12 Cal. W.N. 28.
[2]A.I.R. (1955), Mad. 648.

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or position of the servant (*Laxminarayan Ram Gopal & Sons Ltd.* vs *Hyderabad Govt.*[3]).

Distinction between Agent and Independent Contractor

An independent contractor is one who is employed to perform certain specified work but the manner and means of performance are entirely left to his discretion. He is free to do the specified job independently of the employer's control or interference. Such a contractor also differs from an agent. The main point of distinction is that while the contractor does not represent his employer in relation to other persons and as such cannot bind the employer by contracts entered into with others, the agent, on the other hand, does represent his employer in relation to other persons and can bind the employer (his principal) by contracts entered into with other persons within the scope of his authority.

Who may Employ Agent?

According to Section 183, "any person who is of the age of majority according to the law to which he is subject, and who is of sound mind, may employ an agent." As such any person competent to contract may employ an agent and a minor, a lunatic or a drunken person cannot employ an agent.

Who may be an Agent?

Section 184 lays down in this regard that "as between the principal and third persons *any person* may become an agent." Thus even a minor or a person of unsound mind can be appointed as agent. It is so because the act of the agent is the act of the principal and therefore the principal is liable to third parties for the acts of a minor agent. Of course, in appointing a minor or a person of unsound mind as an agent, the principal runs a great risk because he cannot hold such an agent liable for his misconduct or negligence.

No Consideration is Necessary

"No consideration is necessary to create an agency" (Sec. 185). The fact that the principal has agreed to be represented by the agent is a sufficient 'detriment' to the principal to support the contract of agency *i.e.*, to support the promise by the agent to act in that capacity. It is to be noted, however, that a gratuitous agent is not bound to do the work entrusted to him by his principal. But once he begins the work, he is bound to complete it. Usually an agent is paid remuneration for his services.

[3]A.I.R. (1954), S.C. 364.

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Kinds of Agents

From the point of view of *the extent of their authority,* agents may be classified into:

1. **General agent.** A general agent is one who is employed to do all acts connected with a particular business or employment, *e.g.,* a manager of a firm. He can bind the principal by doing any thing which falls within the ordinary scope of that business, whether he is actually authorised for any particular act or not, is immaterial, provided the third party acts *bonafide.* Third parties may assume that such an agent has power to do all that which is usual for a general agent to do in the business concerned.

2. **Special agent.** A special agent is one who is employed to do some particular act or represent his principal in some particular transaction, *e.g.,* an agent employed to sell a motor car. As soon as the act is performed, the authority of such an agent comes to an end. If a special agent does any thing outside his authority, the principal is not bound by it, and third parties are not entitled to assume that the agent has unlimited powers. They should, therefore, make proper enquiry as to the extent of his authority before entering into any contract with him.

3. **Universal agent.** A universal agent is said to be one whose authority is unlimited *i.e.*, who is authorised to do all the acts which the principal can lawfully do and can delegate. He enjoys extensive powers to transact every kind of business on behalf of his principal.

Another classification. From the point of view of *the nature of work performed* by them, agents may be classified into:

1. **Mercantile agents.** A mercantile agent is one who has authority either to sell goods or to buy goods or to raise money on the security of goods [Sec. 2(9) of the Sale of Goods Act]. The various kind of mercantile agents are as follows:

(*a*) *Factor.* A factor is a mercantile agent to whom goods are entrusted for sale. He enjoys wide discretionary powers in relation to the sale of goods. He sells the goods in his own name upon such terms as he thinks fit. He may pledge the goods as well.

(*b*) *Commission agent.* A commission agent is a mercantile agent who buys or sells goods for his principal on the best possible terms in his own name and who receives commission for his labours. He may have possession of goods or not.

(*c*) *Del credere agent.* He is one who in consideration of an extra commission, guarantees his principal that the third persons with whom he enters into contracts on behalf of the principal shall perform their financial obligations, that is, if the buyer does not pay, he will pay. Thus, he occupies the position of a surety as well as of an agent.

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(*d*) *Broker.* He is one who is employed to make contracts for the purchase and sale of goods. He is not entrusted with the possession of goods. He simply acts as a connecting link and brings the two parties together to bargain and if the transaction materialises he becomes entitled to his ommission called brokerage. He makes contracts in the name of his principal.

2. **Non-mercantile agents.** They include advocates, attorneys, insurance agent, wife, *etc.*

CREATION OF AGENCY

An agency may be created in any one of the following ways:

1. **Agency by Express Agreement**

Normally agency is created by an express agreement, specifying the scope of the authority of agent. The agent may, in such a case, be appointed either by word of mouth or by an agreement in writing (Sec. 187). However, in certain cases *e.g.,* to execute a deed for sale or purchase of land, the agent must be appointed by executing a formal 'power of attorney' on a stamped paper.

2. **Agency by Implied Agreement**

Implied agency arises when there is no express agreement appointing a person as an agent, but instead the existence of agency is inferred from the circumstances of the case, or from the conduct of the parties on a particular occasion, or from the relationship between parties (Sec. 187). Such an agency may take the following forms:

(*a*) Agency by estoppel;
(*b*) Agency by holding out;
(*c*) Agency by necessity.

We shall deal with each of these in turn.

(*a*) **Agency by estoppel.** Such an agency is based on the 'doctrine of estoppel' which may briefly be stated thus, "Where a person by his words or conduct has wilfully led another to believe that certain set of circumstances or facts exists, and that other person has acted on that belief, he is estopped or precluded from denying the truth of such statements, although such a state of things did not in fact exist."

Section 237 of the Contract Act, which deals with agency by estoppel, also provides to the same effect. The Section lays down that "when an agent has, without authority, done acts or incurred obligations to third persons on behalf of his principal, the principal is bound by such acts or obligations, if he has by his words or conduct induced such third persons to believe that such acts and obligations were within the scope of agent's authority."

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We may sum up thus, an agency by estoppel is created when the alleged principal by his conduct or by words spoken or written, leads wilfully the other contracting party into an honest belief that the supposed agent had authority to act as such and bind the principal. Such a principal will be estopped from denying subsequently his agent's authority, although the agent did not in fact possess any authority whatever.

ILLUSTRATIONS. (*a*) *T* tells *M* in the presence and within the hearing of *N* that he (*T*) is *N*'s agent. *N* does not contradict this statement and keeps quiet. Later on *M* enters into a transaction with *T* believing honestly that *T* is *N*'s agent. *N* is bound by this transaction and he will be estopped from denying the existence of the agency, even though such an agency did not in fact exist. Notice that by virtue of the doctrine of estoppel an apparent or ostensible agency becomes as effective as an agency deliberately created.

(*b*) *A* consigns goods to *B* for sale and gives him instruction not to sell under a fixed price. *C*, being ignorant of *B*'s instruction, enters into a contract with *B* to buy the goods at a price lower than the reserved price. *A* is bound by the contract. [Illustration (*a*) to Section 237]

(*b*) **Agency by holding out**. Such an agency is based on the "doctrine of holding out" which is a part of the law of estoppel. In this case also the alleged principal is bound by the acts of the supposed agent, if he has induced third persons to believe that they are done with his authority. But, unlike an 'agency by estoppel', an 'agency by holding out' requires some *affirmative or positive act or conduct* by the principal to establish agency subsequently. Thus, where an employer has been accustomed to pay for goods bought on his behalf by his employee from *P*, the employer may be liable for a purchase made in the customary manner, even though it is made by the employee fraudulently after he has left the employment. The employer's conduct in 'holding out' his employee to be his agent (paying for purchases made by the employee on previous occasions) estops him from denying that his authority was not still in existence.

It may be noted that where the agent is 'held out' as having only a 'limited authority' to do acts, the principal is not bound by an act outside the authority

(*c*) **Agency by necessity.** In certain circumstances the law confers an authority on one person to act as agent for another without any regard to the consent of the principal. Such an agency is called an agency of necessity.[4] Bowstead has rightly observed: "An agency by necessity is conferred by law in certain cases, where a person is faced with an emergency in which the property or interests of another are in imminent danger, and it becomes necessary in order to preserve the property or interests, to act before the instructions of the owner can be obtained. The law assumes the consent of the owner to the creation of the relationship of principal and agent." Thus,

[4] *Cf. Anson's Law of Contract,* 23rd Ed. p. 553.

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the conditions which enable a person to act as an agent of necessity of another are as follows:

(*i*) There should be a real necessity for acting on behalf of the principal.

(*ii*) It should be impossible to communicate with the principal within the time available.

(*iii*) The alleged agent should act *bonafide* in the interests of the principal.

Generally the 'agency by necessity' arises in the following cases:

(*i*) *Where the agent exceeds his authority, bonafide, in an emergency.* For example, where *A* consigns fruits to *B* at Allahabad with directions to send them immediately to *C* at Varanasi, and *B*, finding that the fruits are perishing rapidly, sells them at Allahabad itself for the best price obtainable, the sale will bind the principal and the agent cannot be held liable for exceeding his authority as under the circumstances of the case there arises agency of necessity.

(*ii*) *Where the carrier of goods acting as a bailee, does any thing to protect or preserve the goods, in an emergency,* although there is no express authority in that regard. Thus a master of a ship is entitled, in cases of accident and emergency, to sell or pledge the goods in order to save their value and the sale or pledge will bind the cargo owners. Similarly, a land carrier of goods, in case of accident or emergency, becomes an agent of necessity, for example, if a public carrier develops an engine trouble, the driver can pledge a part of the goods loaded thereon in order to raise the money necessary for repairs and the pledge will be binding on the owner of goods. Notice that in these cases it is not practicable to communicate with the principal.

(*iii*) *Where a husband improperly leaves his wife without providing proper means for her sustenance.* In a special circumstance the case of husband and wife also provides an instance of agency by necessity. When the wife has been deserted by the husband and thus forced to live separate from him, the wife is regarded as the agent of necessity of the husband and she has the authority of pledging her husband's credit for necessaries even against her husband's wishes. However, this rule does not apply where the wife improperly leaves the husband.

It is relevant to state that in the ordinary course of things there is an implied agency between the husband and wife and the wife is presumed to have implied authority to pledge her husband's credit for necessaries suiting to the couple's joint style of living. But a husband enjoys no corresponding right to pledge his wife's credit for necessaries.

3. Agency by Ratification

Ratification means the subsequent adoption and acceptance of an act

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originally done without instructions or authority. Thus where a principal affirms or adopts the unauthorised act of his agent, he is said to have ratified that act and there comes into existence an agency by ratification retrospectively.

Section 196 deals with the effect of 'ratification.' It provides that "where acts are done by one person on behalf of another, but without his knowledge or authority, he may elect to ratify or to disown such acts. If he ratifies them, the same effects will follow as if they had been performed by his authority."

ILLUSTRATION. *A* buys 5 bags of wheat on behalf of *B*. *B* did not appoint *A* as his agent. *B* may, upon hearing of the transaction, accept or reject it. If *B* accepts it, the act is ratified and *A* becomes his agent with retrospective effect.

Ratification relates back to time of contract. As observed above, ratification has got retrospective effect. By ratifying the unauthorised act of the agent, the principal becomes bound by the act as if it had been originally done by his authority. Thus ratification amounts to 'prior authority'. It relates back to the original making of the contract. This means that the agency comes into existence from the moment the agent acted and not from the time when the principal ratified.

ILLUSTRATION. The managing director of a company, purporting to act as agent on company's behalf, but without its authority, accepted an offer made by L, the defendant, for the purchase of some sugar works belonging to them. *L*, subsequently withdrew the offer but the company ratified the managing director's acceptance. *Held, L* was bound. The ratification, related back to the time of managing director's acceptance, and so the withdrawal of the offer was inoperative. An offer once accepted cannot be withdrawn. *(Bolton* vs *Lambert*[5])

Ratification may be express or implied. Section 197 provides; "Ratification may be expressed or may be implied in the conduct of the person on whose behalf the acts are done."

ILLUSTRATIONS (appended to Sec. 197). (*a*) *A*, without authority, buys goods for *B*. Afterwards *B* sells them to *C* on his own account. *B*'s conduct implies a ratification of the purchase made by *A* for him.

(*b*) *A*, without *B*'s authority, lends *B's* money to *C*. Afterwards *B* accepts interest on the money from *C*. *B*'s conduct implies a ratification of the loan.

Essentials of a valid ratification. A valid ratification must fulfil the following conditions:

1. *The agent must purport to act as agent for a principal who is in contemplation.* The agent must expressly contract as an agent for a principal in the knowledge of third parties. The principal must be named or must be 'identifiable' and it is not sufficient to indicate simply that he is acting as agent of some one. The word 'identifiable' here means that there must be such a description of the principal as shall amount to a reasonable desig-

[5](1889), 41 Ch. D. 295.

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nation of him, for example, it would cover the expressions like "on behalf of the Vice-Chancellor, Delhi University" or "on behalf of my elder brother." Thus, to be valid, a ratification must be done by the person on whose behalf the agent professed to act. An undisclosed principal cannot step in and ratify acts done by a third person. Similarly, a person entering into a contract in his own name cannot later shift it on to a third party.

2. *There should be an act capable of ratification.* The act to be ratified must be a lawful one. There can be no ratification of an illegal act or an act which is void. Thus, the shareholders of a company cannot ratify an *ultra vires* contract made by the directors.

3. *The principal must be in existence.* For a valid ratification it is essential that the principal must be in existence at the time when the original contract is made, because rights and obligations cannot attach to a non-existent person. Thus contracts, entered into by promoters of a company on its behalf before its incorporation, cannot be ratified by the company after it comes into existence. The Specific Relief Act, however, provides for certain exceptions where a company can ratify its pre-incorporation contracts.[6]

4. *The principal must be competent to contract.* The principal must have contractual capacity both at the time of original contract and at the time of ratification. Thus a person cannot ratify a contract made on his behalf during his minority. Similarly, a person cannot ratify a contract of insurance made by an unauthorised agent on his behalf after he has become aware that the event insured against has in fact occurred, because he could not himself insure in such circumstances (*Grover & Grover* vs *Mathews*[7]).

5. *The principal must have full knowledge of material facts.* Section 198 declares: "No valid ratification can be made by a person whose knowledge of facts of the case is materially defective." Thus to constitute a valid ratification, the principal must, at the time of ratification, have full knowledge of all material facts or give such an unqualified acceptance that the inference may be drawn that he intended to ratify the contract whatever the facts may be.

6. *Whole transaction must be ratified.* Ratification must be of the whole contract. Once a part is accepted, it is an implied acceptance of the whole (Sec. 199). There cannot be partial rejection and partial ratification. The principal cannot reject the burdens attached and accept only the benefits.

7. *Within reasonable time.* A ratification to be effective must be made within a reasonable time after the original contract is made. Where a time is expressly fixed for the performance of the contract, ratification must be made within that time.

[6]See Sections 15 (*h*) and 19 (*e*) of the *Specific Relief Act, 1963.*
[7](1910), 2 K.B. 401.

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8. *Ratification must not injure a third person* (Sec. 200). A ratification cannot be effective where its effect is to subject a third person to damages, or terminate any right or interest of a third person.

ILLUSTRATIONS (appended to Sec. 200). (*a*) *A*, not being authorised thereto by *B*, demands on behalf of *B*, the delivery of a chattel, the property of *B*, from *C*, who is in possession of it. This demand cannot be ratified by *B*, so as to make *C* liable for damages for his refusal to deliver.

(*b*) *A* holds a lease from *B*, terminable on three months' notice. *C*, an unauthorised person, gives notice of termination to *A*. The notice cannot be ratified by *B*, so as to be binding on *A*.

Extent of Agent's Authority

The authority of an agent means his capacity to bind the principal to third parties. The agent can bind the principal only if he acts within the scope of his authority. The scope of an agent's authority is determined by his:

1. **Actual authority.** An agent can do all such acts as have been assigned to him either expressly or impliedly and thereby bind the principal to third parties by acts done within the scope of his 'actual' or 'real' authority (Secs. 186 and 226). The authority is said to be *express* when it is given by words spoken or written. The authority is said to be *implied* when it is inferred from the circumstances of the case or the ordinary course of dealings (Sec. 187).

2. **Ostensible or apparent authority.** An agent can also bind the principal to third parties by acts done within his *apparent* authority; (although the act is in excess of his actual authority); provided the third party acts *bonafide* and without knowledge of the limitation of the agent's apparent authority (*Watteau* vs *Fenwick*[8]). Thus 'actual' and 'apparent' authority stand on the same footing.

Ostensible authority means an authority which the third parties dealing with the agent can presume to be with the agent in relation to a particular business ordinarily. In other words, such an authority implies authority to do an act usually necessary in the course of conducting similar business in accordance with the customs and usages of the particular place, trade or market. Thus if it is the usual practice of hotel managers to purchase liquors and cigarettes, then purchases of this nature shall be deemed within the scope of the manager's apparent authority and the principal will be bound by such purchases, notwithstanding limitations, as between the principal and agent, put upon that authority (*Watteau* vs *Fenwick*[9]).

Section 188 which deals with the extent of agent's authority lays down

[8](1893), 1 Q.B. 346.
[9]*Ibid.*

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the scope of an agent's apparent authority in these words: "An agent having an authority to do an act or to carry on a business has authority to do every lawful thing which is necessary in order to do such act, or which is usually done in the course of conducting such business." The following *illustrations* are appended to the Section:

ILLUSTRATIONS. (*a*) *A,* is employed by *B*, residing in London, to recover at Bombay a debt due to *B*. *A* may adopt any legal process necessary for the purpose of recovering the debt, and may give a valid discharge for the same.

(*b*) *A* constitutes *B*, his agent, to carry on his business of a ship-builder. *B* may purchase timber and other materials, and hire workmen, for the purpose of carrying on the business.

In normal times, therefore, the scope of an agent's authority is determined by his 'actual' as well as 'apparent' authority. Although the apparent authority of an agent may be curtailed by the principal but such a curtailment is ineffective *vis-a-vis* the principal and third parties unless the third parties have notice of it. Even if an act of the agent is in excess of his actual authority, the principal will be bound by the act if it is within the scope of the agent's apparent authority, provided the third parties act *bonafide.* Thus, if a principal delivers goods to a 'factor' with instructions that they are not to be disposed of but are to be retained pending further instructions; and the factor, in breach of his authority, sells the goods to a third party who acts *bonafide* for value, then the principal (owner) is estopped from disputing the validity of the transaction since it is within the scope of apparent authority of a factor to dispose of the goods of which he is in possession.

3. **Authority in emergency.** An agent has authority, in an emergency, to do all such acts for the purpose of protecting his principal from loss as would be done by a person of ordinary prudence in his own case, under similar circumstances (Sec. 189). The following *illustrations* are appended to the Section:

ILLUSTRATIONS. (*a*) An agent for sale may have goods repaired if it be necessary.

(*b*) *A* consigns provisions to *B* at Calcutta, with directions to send them immediately to *C* at Cuttack. *B* may sell the provisions at Calcutta, if they will not bear the journey to Cuttack without spoiling.

Delegation of Authority

Section 190 provides that "an agent cannot lawfully employ another to perform acts which he has expressly or impliedly undertaken to perform personally, unless by the ordinary custom of trade a sub-agent may, or from the nature of agency, a sub-agent must, be employed." Accordingly an agent cannot delegate his powers or duties to another without the express authority of the principal, except in certain cases (which are discussed in the next paragraph). This Section is based on the well-known maxim of

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Roman law, *viz.*, "*delegatus nonpotest delegare,*" that is "a delegate cannot further delegate." An agent, being himself a delegate of his principal, cannot pass on that delegated authority to someone else. As a rule, he must not depute another person to do that which he has undertaken to do personally. The reason for this rule is that confidence in the integrity and competence of a particular person is at the root of a contract of agency.

But there are *exceptions* to this general rule. In the following cases the agent can delegate his authority to another *(i.e.,* can appoint a sub-agent) and bind the principal:

1. Where the principal has expressly permitted delegation of such power.

2. Where the principal has impliedly, by his conduct, allowed such delegation of authority, *e.g.,* where the principal knows that the agent intends to delegate his authority but does not object to it.

3. Where by the ordinary custom of trade a sub-agent may be employed. Thus stock exchange member brokers generally appoint clerks to transact business on behalf of their clients.

4. Where the very nature of agency makes it necessary to appoint a sub-agent. For example, a manager of a shop may employ sales assistant.

5. Where the acts to be done are purely ministerial and do not involve the exercise of discretion, *e.g.,* clerical or routine work.

6. Where unforeseen emergencies arise rendering appointment of the sub-agent necessary.

If a sub-agent is appointed in any of the above circumstances, then he is called as "properly appointed sub-agent."

Sub-Agent

"A sub-agent is a person employed by, and acting under the control of, the original agent in the business of the agency" (Sec. 191). Thus a person employed by an agent is called a sub-agent. A sub-agent acts under the control of the original agent as for the relation in between themselves is that of agent and principal. In other words the original agent acts as principal for the sub-agent.

Consequences of the appointment of sub-agent. The legal effects of the appointment of a sub-agent as between the principal and the sub-agent *inter se* and as regards third parties depend upon whether the sub-agent has been properly or improperly appointed. A sub-agent is said to be properly appointed when the appointment is made under any of the recognised exceptional circumstances discussed under the preceding heading. The appointment is said to be improper when it is made without any justification for such appointment.

Where a sub-agent is properly appointed. In such a case, as per Section 192, the following consequences emerge:

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(*a*) The principal is bound and liable to third parties for the acts of the sub-agent, as if he were an agent originally appointed by the principal.

(*b*) The agent is responsible to the principal for the acts of the sub-agent. For example, if any moneys are due on the sub-agent, the agent is responsible for the same and the principal cannot sue the sub-agent on that account. It is so because in the eye of law there is no privity of contract between the principal and the sub-agent and therefore, in general, the principal cannot claim against the sub-agent for negligence (*Calico Printers Association* vs *Barclays Bank*[10]).

(*c*) The sub-agent is responsible for his acts to the agent and not to the principal. But in case the sub-agent is guilty of fraud or wilful wrong, he is directly liable to the principal. In such a case the principal has the choice to sue either the agent or the sub-agent (*Nensukhdas* vs *Birdichand*[11]).

Where a sub-agent is improperly appointed. Where the appointment of a sub-agent is made without authority and without any justification, as per Section 193, the following consequences arise:

(*a*) The principal is not represented by such sub-agent and hence he is not liable for the acts of the sub-agent.

(*b*) The agent is responsible for the acts of the sub-agent to the principal as well as to the third parties.

(*c*) The sub-agent is not responsible to the principal at all. He cannot be held liable by the principal even for fraud or wilful wrong. He is responsible for his acts only to the agent (his employer).

Substituted Agent

Section 194 deals with the appointment of a substituted agent. Accordingly, "when an agent has an express or implied authority of his principal to name another person to act for the principal and the agent names another person accordingly, such person is not a sub-agent but a substituted agent of the principal in respect of the business which is entrusted to him". Thus an agent simply names or appoints a substituted agent at the request of the principal and thereafter drops out altogether from the scene. The substituted agent is directly responsible to the principal and a privity of contract is deemed between him and the principal.

ILLUSTRATIONS (appended to Sec. 194). (*a*) *A* directs *B*, his solicitor, to sell his estate by auction and to employ an auctioneer for the purpose. *B* names *C*, an auctioneer, to conduct the sale. *C* is not a sub-agent, but is *A*'s agent for the conduct of the sale.

(*b*) *A* authorises *B*, a merchant in Calcutta, to recover the moneys due to *A* from *C* & Co. *B* instructs *D*, a solicitor, to take legal proceedings against *C* & Co.,

[10](1931), 145 L.T. 51.
[11](1917), 19 Bom. L.R. 948.

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for the recovery of the money. *D* is not a sub-agent, but a full-fledged agent of *A*.

Section 195 imposes a duty on the original agent to act with reasonable care while naming a substituted agent. The Section lays down that "in selecting such agent for his principal, an agent is bound to exercise the same amount of discretion as a man of ordinary prudence would exercise in his own case; and if he does this, he is not responsible to the principal for the acts or negligence of the agent so selected." Thus the original agent must act with reasonable care in selecting a substituted agent. If he makes the selection carelessly, he becomes liable to the principal for the negligence of the agent so selected. It may by noted, however, that the original agent is not required to guarantee the integrity or solvency of the substituted agent.

ILLUSTRATIONS (appended to Sec. 195). (*a*) *A* instructs *B*, a merchant, to buy a ship for him. *B* employs a ship surveyor *of good reputation* to choose a ship for *A*. The surveyor makes the choice negligently and the ship turns out to be unseaworthy and is lost. The surveyor, but not the agent, is liable to *A*, the principal.

(*b*) *A* consigns goods to *B*, a merchant, for sale. *B*, in due course, employs an auctioneer *in good credit* to sell the goods of *A*, and allows the auctioneer to receive the proceeds of the sale. The auctioneer afterwards becomes insolvent without having accounted for the proceeds. *B* is not responsible to *A* for the proceeds. (*B* would have been responsible to *A* for the proceeds if the auctioneer so employed were a known man of doubtful credit).

Duties of Agent

An agent has the following duties towards the principal:

1. **Duty to follow principal's directions or customs** (Sec. 211). The first duty of every agent is to act within the scope of the authority conferred upon him and perform the agency work according to the directions given by the principal. When the agent acts otherwise, if any loss be sustained, he must make it good to the principal, and if any profit accrues, he must account for it.

ILLUSTRATIONS. (*a*) Where the principal instructed the agent to warehouse the goods at a particular place and the agent warehoused them at a different warehouse which was equally safe, and the goods were destroyed by fire without negligence, it was held that the agent was liable for the loss because any departure from the instructions makes the agent absolutely liable (*Lilley* vs *Doubleday*[12]).

(*b*) An agent being instructed to insure goods neglects to do so. He is liable to compensate the principal in the event of their being lost (*Pannalal Jankidas* vs *Mohanlal*[13]).

If the principal has not given any express or implied directions, then

[12](1881), 7 QBD 510.
[13]A.I.R. (1951) S.C. 144.

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it is the duty of the agent to follow the custom prevailing in the same kind of business at the place where the agent conducts business. If the agent makes any departure, he does so at his own risk. He must make good any loss so sustained by the principal.

ILLUSTRATIONS (appended to Sec. 211). (*a*) *A*, an agent, engaged in carrying on for *B* a business, in which it is the custom to invest from time to time at interest, the moneys which may be in hand, omits to make such investments. *A* must make good to *B* the interest usually obtained by such investments.

(*b*) *B*, a broker, in whose business it is not the custom to sell on credit, sells goods of *A* on credit to *C*, whose credit at the time was very high. *C*, before payment, becomes insolvent. *B* must make good the loss to *A*, irrespective of his good intentions.

2. **Duty to carry out the work with reasonable skill and diligence** (Sec. 212). The agent must conduct the business of the agency with as much skill as is generally possessed by persons engaged in similar business, unless the principal has notice of his want of skill. Further, the agent must act with reasonable diligence and to the best of his skill.

If the agent does not work with reasonable care, skill (unless the principal has notice of his want of skill) and diligence, he must make compensation to his principal in respect of 'direct consequences' of his own neglect, want of skill or misconduct. But he is not so liable for indirect or remote losses.

ILLUSTRATIONS (appended to Sec. 212). (*a*) *A*, a merchant in Calcutta, has an agent *B*, in London, to whom a sum of money is paid on *A's* account, with orders to remit. *B* retains the money for a considerable time. *A*, in consequence of not receiving the money, becomes insolvent. *B* is liable for the money and interest from the day on which it ought to have been paid, according to the usual rate, and for any further direct loss such as loss by variation of rate of exchange, but nothing further.

(*b*) *A*, an agent for the sale of goods, having authority to sell goods on credit, sells to *B* on credit, without making the proper and usual enquiries as to the solvency of *B*. *B*, at the time of such sale, is insolvent. *A* must make compensation to his principal in respect of any loss thereby sustained.

(*c*) *A*, an insurance broker, employed by *B* to effect an insurance on a ship, omits to see that the usual clauses are inserted in the policy. The ship is afterwards lost. In consequence of the omission of the clauses nothing can be recovered from the underwriters. *A* is bound to make good the loss to *B*.

(*d*) *A*, a merchant in England, directs *B*, his agent at Bombay, who accepts the agency, to send him 100 bales of cotton by a certain ship. *B*, having it in his power to send the cotton, omits to do so. The ship arrives safely in England. Soon after her arrival the price of cotton rises. *B* is bound to make good to *A* the profit which he might have made by the 100 bales of cotton at the time the ship arrived, but not any profit he might have made by the subsequent rise.

3. **Duty to render accounts** (Sec. 213). It is the duty of an agent to

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keep proper accounts of his principal's money or property and render them to him on demand, or periodically if so provided in the agreement.

4. **Duty to communicate** (Sec. 214). It is the duty of an agent, in cases of difficulty, to use all reasonable diligence in communicating with his principal, and in seeking to obtain his instructions, before taking any steps in facing the difficulty or emergency.

5. **Duty not to deal on his own account** (Secs. 215 and 216). An agent must not deal on his own account in the business of agency; *i.e.,* he must not himself buy from or sell to his principal goods he is asked to sell or buy on behalf of his principal; without obtaining the consent of his principal after disclosing all material facts to him. If the agent violates this rule, the principal may repudiate the transaction where it can be shown that any material fact has been knowingly concealed by the agent, or that the dealings of the agent have been disadvantageous to the principal. The principal is also entitled to claim from the agent any benefit which may have resulted to him from the transaction.

ILLUSTRATIONS. (*a*) *A*, directs *B* to sell *A*'s estate. *B* buys the estate for himself in the name of *C*. *A*, on discovering that *B* has bought the estate for himself, may repudiate the sale, if he can show that *B* has dishonestly concealed any material fact or that the sale has been disadvantageous to him. [Illustration (a) appended to Section 215]

(*b*) *A* directs *B* to sell *A*'s estate. *B*, on looking over the estate before selling it, finds a mine on the estate which is unknown to *A*. *B* informs *A* that he wishes to buy the estate for himself but conceals the discovery of the mine. *A* allows *B* to buy, in ignorance of the existence of the mine. *A*, on discovering that *B* knew of the mine at the time he bought the estate, may either repudiate or adopt the sale at his option. [Illustration (*b*) appended to Section 215]

(*c*) *A* directs, *B*, his agent, to buy a certain house for him. *B* tells *A* that it cannot be bought and buys the house for himself, *A* may, on discovering that *B* has bought the house, compel him to sell it to *A* at the price he gave for it. [Illustration appended to section 216]

6. **Duty not to make any profit out of his agency except his remuneration** (Secs. 217 and 218). An agent stands in a fiduciary relation to his principal and therefore he must not make any profit (secret profit) out of his agency. He must pay to his principal all moneys (including illegal gratification, if any) received by him on principal's account. He can, however, deduct all moneys due to himself in respect of his remuneration or/ and expenses properly incurred. If his acts are not *bonafide,* he will lose his remuneration and will have to account for the secret profit to his principal.

7. **Duty on termination of agency by principal's death or insanity** (Sec. 209). When an agency is terminated by the principal dying or becoming of unsound mind, the agent must take, on behalf of the representatives

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of his late principal, all reasonable steps for the protection and preservation of the interests entrusted to him.

8. **Duty not to delegate authority** (Sec. 190). Subject to six exceptions stated earlier (under the heading *Delegation of Authority)*, an agent must not further delegate his authority to another person, but perform the work of agency himself.[14]

Rights of Agent

An agent has the following rights against the principal:

1. **Right to receive remuneration** (Secs. 219 and 220). The agent is entitled to receive his agreed remuneration, or if nothing is agreed, to a reasonable remuneration, unless he agrees to act gratuitously. In the absence of any special contract, the right to claim remuneration arises only when the agent has done what he had undertaken to do. It is important that the agent can claim remuneration once he has completed his work even though the contract is never executed on account of breach either by the principal or the third party. For example, where an agent is appointed to secure orders for the manufacturer, he can claim commission on orders actually obtained by him although the manufacturer is unable to execute them owing to a strike by the workmen.

Effect of misconduct. An agent who is guilty of misconduct in the business of the agency is not entitled to any remuneration in respect of that part of the business which he has misconducted. In addition, he is liable to compensate the principal for any loss caused by the misconduct.

ILLUSTRATIONS (appended to Sec. 220). (*a*) *A* employs *B* to recover 1,00,000 rupees from *C*, and to lay it out on good security. *B* recovers the 1,00,000 rupees and lays out 90,000 rupees on good security, but lays out 10,000 rupees on security which he ought to have known to be bad, whereby *A* loses 2,000 rupees. *B* is entitled to remuneration for recovering the 1,00,000 rupees and for investing the 90,000 rupees, He is not entitled to any remuneration for investing the 10,000 rupees and he must make good the loss of 2,000 rupees to *A*.

(*b*) *A* employs *B* to recover Rs 1,000 from *C*. Through *B*'s misconduct the money is not recovered (the debt might have become time-barred because of *B*'s negligence or leniency). *B* is entitled to no remuneration for his services and must make good the loss to *A*.

2. **Right of retainer** (Sec. 217). An agent has the right to retain, out of any sums received on account of the principal, all moneys due to himself in respect of his remuneration, or advances made or expenses properly incurred by him in conducting the business of agency.

3. **Right of lien** (Sec. 221). An agent has the right to retain goods,

[14]For further details *see Delegation of Authority* discussed earlier in this Chapter.

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papers and other property, whether movable or immovable, of the principal received by him, until the amount due to himself for commission, disbursements and services in respect of the same has been paid or accounted for to him. This right is, however, subject to a contract to the contrary. Again, this lien of the agent is a "particular lien."[15] But by a special conract an agent may have a general lien also. It may be recalled that by virtue of Section 171 factors, bankers, attorneys of High Court and policy brokers have a "general lien,"[15] in the absence of a contract to the contrary.

It is to be noted that this right of lien of the agent is subject to all rights and equities of third parties against the principal, that is, if the agent has sold the goods, he will have to give delivery to the buyer (*London and Joint Stock Bank vs Simmons*[16]).

4. **Right to be indemnified against consequences of lawful acts.** (Sec. 222). An agent has also the right to be indemnified against the consequences of all lawful acts done by him in exercise of the authority conferred upon him.

ILLUSTRATIONS (appended to Sec. 222). (*a*) *B*, at Singapore, under instructions from *A* of Calcutta, contracts with *C* to deliver certain goods to him. *A* does not send the goods to *B* and *C* sues *B* for breach of contract. *B* informs *A* of the suit, and *A* authorises him to defend the suit. *B* defends the suit and is compelled to pay damages and costs, and incurs expenses. *A* is liable to *B* for such damages, costs and expenses.

(*b*) *B*, a broker at Calcutta, by the orders of *A*, merchant there, contracts with *C* for the purchase of 10 casks of oil for *A*. Afterwards *A* refuses to receive the oil, and *C* sues *B*. *B* informs *A*, who repudiates the contract altogether. *B* defends, but unsuccessfully, and has to pay damages and costs and incurs expenses. *A* is liable to *B* for such damages, costs and expenses.

It may be noted that the agent cannot claim indemnity in respect of acts which are apparently unlawful or criminal (Sec. 224).

ILLUSTRATIONS (appended to Sec. 224). (*a*) *A* employs *B* to beat *C* and agrees to indemnify him against all consequences of the act. *B* thereupon beats *C* and has to pay damages to *C* for so doing. *A* is not liable to indemnify *B* for those damages.

(*b*) *B*, the proprietor of a newspaper, publishes, at *A*'s request, a libel upon *C* in the paper and *A* agrees to indemnify *B* against the consequences of the publication and all costs and damages of any action in respect thereof. *B* is sued by *C* and has to pay damages and also incurs expenses. *A* is not liable to *B* upon the indemnity.

5. **Right to be indemnified against consequences of acts done in good faith** (Sec. 223). An agent has a right to be indemnified against the consequences of an act done in good faith though it turns out to be injurious to the rights of third persons.

[15]For further details see Chapter 14—*Bailment and Pledge.*
[16](1892), A.C. 201.

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ILLUSTRATIONS (appended to Sec. 223). (*a*) *A*, a decree holder and entitled to execution of *B*'s goods, requires the officer of the Court to seize certain goods, representing them to be the goods of *B*. The officer seizes the goods, and is sued by *C*, the true owner of the goods. *A* is liable to indemnify the officer for the sum which he is compelled to pay to *C* in consequence of obeying *A*'s directions.

(*b*) *B*, at the request of *A*, sells goods in the possession of *A*, but which *A* had no right to dispose of. *B* does not know this and hands over the proceeds of the sale to *A*. Afterwards *C*, the true owner of the goods, sues *B* and recovers the value of the goods and costs. *A* is liable to indemnify *B* for what he has been compelled to pay to *C* and for *B*'s own expenses.

6. **Right to compensation.** (Sec. 225). The agent has a right to be compensated for injuries sustained by him due to the principal's neglect or want to skill.

ILLUSTRATION (appended to Sec. 225). *A* employs *B* as a bricklayer in building a house, and puts up the scaffolding himself. The scaffolding is unskilfully put up and *B* is in consequence hurt. *A* must make compensation to *B*.

7. **Right of stoppage of goods in transit.** An agent has a right to stop the goods in transit to the principal (just like an unpaid seller), if (*i*) he has bought goods either with his own money or by incurring a personal liability for the price and (*ii*) the principal has become insolvent.

Rights and Duties of Principal

The duties of an agent are indirectly the rights of a principal and the rights of an agent are indirectly the duties of a principal. The duties and rights of an agent have already been discussed in earlier pages.

Principal's Liability for the Acts of the Agent

The extent of principal's liability to third parties for the acts of the agent is determined by the following rules:

1. **When agent acts within the scope of his actual and apparent authority.** The principal is liable for all acts of the agent done within the scope of his 'actual' and 'apparent' (ostensible) authority."[17] The fact that a particular act of the agent is in excess of his actual authority does not affect the principal's liability and the principal remains liable therefore as usual, provided the act in question is within the scope of the agent's apparent authority and the third party acts *bonafide* without knowledge of the curtailment. The principal is also liable for all such acts of the agent which are necessary for protecting the principal from loss in an emergency (Sec. 189).

2. **When agent exceeds his actual as well as apparent authority.** In this case the principal has option either to disown the unauthorised acts or

[17]Sections 186, 226 and 188. For details see *Extent of Agent's Authority* discussed earlier in this Chapter.

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to ratify the same. Where he ratifies, he becomes liable for those acts as if he had authorised them originally but where he opts to disown them, the following rules shall apply:

(*a*) Where the excess is separable from the authorised portion, the principal is liable only for the authorised portion (Sec. 227).

ILLUSTRATION (to Sec. 227). *A*, being owner of a ship and cargo, authorises *B*[18] to procure an insurance for Rs 4,000 on the ship. *B* procures a policy for Rs 4,000 on the ship, and another for the like sum on the cargo. *A* is bound to pay the premium for the policy on the ship but not the premium for the policy on the cargo. (If *B* had taken only one policy on the ship and the cargo, *A* would not have been bound at all).

(*b*) Where the excess is not separable from the authorised portion, the principal is not bound by the transaction. In such a case the principal is entitled to repudiate the whole transaction and the agent shall be personally liable for that (Sec. 228).

ILLUSTRATION (to Sec. 228). *A* authorises *B* to buy 500 sheep for him. *B* buys 500 sheep and 200 lambs for one sum of Rs 6,000. *A* may repudiate the whole transaction.

3. **Liability for agent's misrepresentation or fraud** (Sec. 238). The principal is liable for misrepresentation made or fraud committed by the agent acting within the scope of his actual or apparent authority during the course of the agency business. For this purpose also the law treats the principal and his agent as one and it is immaterial which of them makes the false statement or commits the fraud.

It is to be noted that the only condition of the principal's liability is that the act in question must be done within the course of the agency business and it does not matter whether the agent has done the act for his personal benefit or for the benefit of the principal, or whether the wrongful act was authorised by the principal or not.

The principal is not liable for misrepresentation made or fraud committed by the agent in matters which do not fall within his authority.

ILLUSTRATIONS (appended to Sec. 238). (*a*) *A*, being *B*'s agent for the sale of goods, induces *C* to buy them by a misrepresentation, which he was not authorised by *B* to make. The contract is voidable, as between *B* and *C*, at the option of *C*.

(*b*) *A*, the captain of *B*'s ship, signs bill of lading without having received on board the goods mentioned therein. The bill of lading is void as between *B* and the pretended consignor.

4. **Notice given to agent as notice to principal** (Sec. 229). The principal is bound by the notice given to or information obtained by the agent in the course of the agency business. Knowledge of the agent is said to be

[18] *B* is an insurance broker and broker is a special agent, whereby the third party is under obligation to find his actual authority. *B* is not *A*'s general agent.

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the knowledge of the principal: the principal is said to have constructive notice. But where knowledge is not acquired by the agent in the course of the agency business, it cannot be imputed to the principal.

ILLUSTRATIONS (appended to Sec. 229). (*a*) *A* is employed by *B* to buy from *C* certain goods of which *C* is the apparent owner. *A* buys them accordingly. In the course of the treaty for the sale, *A* learns that the goods really belonged to *D*, but *B* is ignorant of that fact. *B* is not entitled to set off a debt owing to him from *C* against the price of the goods.

(*b*) *A* is employed by *B* to buy from *C* certain goods of which *C* is the apparent owner. *A* was, before he was so employed, a servant of *C* and then he learnt that the goods really belonged to *D*, but *B* is ignorant of that fact. In spite of the knowledge of his agent, *B* may set off against the price of the goods a debt owing to him from *C*. (Notice that in this case knowledge is not acquired by the agent in the course of agency work and hence it does not have the same effect as if it had been given to the principal.)

5. **Liability based on the doctrine of estoppel** (Sec. 237). Here the liability of the principal is based on the doctrine of estoppel and not on any real authority. A principal, who so acts as to make it appear that he has conferred upon his agent authority to make a certain contract, is estopped from disputing the validity of the contract as against a person who dealt for value with the agent in the *bonafide* belief that the authority had actually been given. Such a principal is bound by the acts of the agent although the agent did not in fact possess any authority in relation to those acts.

ILLUSTRATION. *A*, a merchant, writes to *B*, a customer, that he has authorised his agent *C* to see him, and, if possible to come to an amicable settlement. *A* privately gives instructions to *C* not to settle for less than a certain amount. *C* settles the claim with *B* for an amount less than the amount authorised by *A*. *A* is bound by the settlement, *B* being ignorant of *A*'s private instructions to *C*.

Liability of Unnamed Principal

Unnamed principal means a principal whose existence is disclosed by the agent but the name is not disclosed. Once it is disclosed by the agent that he is an agent, the contract made by the agent binds the principal and the agent drops out of the transaction despite the fact that the principal for whom he acted has not been named. On being discovered, the legal position of the unnamed principal is the same as where the principal is named, unless there is a trade custom making the agent personally liable *e.g.*, in case of stock exchange transactions a jobber can make a broker personally liable. If, however, the agent declines to disclose the identity of the principal, he becomes personally liable on the contract. Also if the agent could not disclose the identity of the principal, say, because of his sudden death, his estate will be liable to third parties. In both these cases the agent himself is deemed as a contracting party and therefore he is made liable to the third parties.

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Liability of Undisclosed Principal

Where an agent, having authority to contract on behalf of another, makes the contract in his own name (as for he is the principal himself), concealing not only the name of his principal but also the fact that there is a principal, his principal is called "undisclosed principal". In such a case neither the existence nor the name of the principal is disclosed and the agent gives an impression to the third party as if he himself is the contracting party although the agent has authority in fact and is contracting on behalf of another.

In the case of an undisclosed principal, the mutual rights and liabilities of the principal, the agent and the third party are as follows:

1. Since the agent has contracted in his own name, he is liable to the third party personally. The agent may be sued on the contract and he has the right to sue the third party, if the undisclosed principal remains undisclosed. (Of course as between the principal and the agent, the agent has every right against the principal.)

2. If the third party comes to know the existence of the principal before obtaining judgment against the agent, he may sue either the principal or the agent or both (Sec. 233).

ILLUSTRATION (appended to Sec. 233). *A* enters into a contract with *B* to sell him 100 bales of cotton and afterwards discovers that *B* was acting as agent for *C*. *A* may sue either *B* or *C*, or both, for the price of the cotton.

It may be noted that the liability of the principal and agent is "joint and several" in such a case. If the third party elects to sue the agent and the claim remains partially unsatisfied, he may afterwards sue the principal for the balance (*T.R. Chettiar vs M.K. Chettiar*[19]). Further, if the third party decides to sue the principal, he must allow the principal the benefit of all payments received by him from the agent.

3. The principal, if he likes, may intervene and sue the third party for non-performance of the contract. But he cannot exercise this right to the prejudice of the third party and the third party has, as against the principal, the same rights as he would have had as against the agent if the agent had been the principal, *e.g.*, right of set-off can be claimed by the third party (Sec. 231, para 1). Further, the principal must allow to the third party benefits of all payments made by the third party to the agent. "The principal, if he requires the performance of the contract, can only obtain such performance subject to the rights and obligations subsisting between the agent and the other party to the contract" (Sec. 232).

ILLUSTRATION (appended to Sec. 232). *A*, who owes Rs 500 to *B*, sells 1,000 rupees worth of rice to *B*. *A* is acting as agent of *C* in the transaction, but *B* has no knowledge nor reasonable ground of suspicion that such is the case. *C* cannot compel *B* to take the rice without allowing him to set-off *A*'s debt.

[19]A.I.R. (1970), Mad. 337.

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4. If the principal discloses himself before the contract is completed, the third party may refuse to fulfil the contract, if he can show that if he had known who was the principal in the contract or if he had known that the agent was not a principal, he would not have entered into the contract (Sec. 231, Para 2).

Liability of Pretended Agent

A person untruly representing himself to be the authorised agent of another, and thereby inducing a third party to deal with him as such agent, is liable, if his alleged employer does not ratify his acts, to make compensation to the other party in respect of any loss or damage which the other party has incurred by so dealing (Sec. 235). In addition, such a pretended agent may also be sued for fraud by the aggrieved party.

It must be noted that although the pretended agent is liable to make compensation to the other contracting party, but he has no right to proceed against that party for the performance of the contract (Sec. 236).

Personal Liability of Agent to Third Party

It has already been observed that an agent is appointed to bring the principal into contractual relations with third parties and the acts of the agent are the acts of the principal. As a rule, therefore, an agent cannot *personally* enforce contracts entered into by him on behalf of the principal, nor can he be *personally* held liable for them, unless there is a contract to the contrary (Sec. 230). The principal is the right person to enforce such contracts and to be held liable therefor.

There are, however, certain exceptions to this rule, where an agent is presumed to be personally liable, unless a contract to the contrary exists.

At the very out set it is worth noting that in certain cases where the agent is personally liable, a person dealing with him may hold either him or his principal or both of them liable (Sec. 233). In other words, the liability of the principal and the agent is 'joint and several' in some cases. Even where the agent is personally liable, the principal is also liable to third parties and hence the saying: "The law which superadds the liability of an agent does not detract from the liability of the principal." The third party dealing with an agent who is personally liable can choose between (*a*) suing both principal and agent, jointly, (*b*) electing to sue one of them. It is important that a judgment obtained against one only and remaining unsatisfied is no bar to a second suit against the other party, *i.e.*, if the third party sues the agent and obtains no satisfaction, he may afterwards sue the principal because the liability is 'joint and several' (*T.R. Chettiar* vs *M.K. Chettiar*[20]).

[20]A.I.R. (1970), Mad. 337.

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An agent is presumed to be personally liable, unless a contract to the contrary exists, in the following cases:

1. **Where the agent expressly agrees.** If an agent, while contracting with a third party, expressly agrees to be personally liable on the contract, he can be held personally liable for any breach of contract.

2. **Where the agent acts for a foreign principal.** Where an agent contracts for the sale or purchase of goods for a merchant residing abroad, he is presumed to be personally liable (Sec. 230).

3. **Where the agent acts for an unnamed principal.** Where an agent acts for an unnamed principal, he is personally liable to the third party, if he declines to disclose the identity of the principal *or* if he could not disclose the identity of the principal, say, because of his sudden death.

4. **Where the agent acts for an undisclosed principal.** Where an agent acts for an undisclosed principal and contracts in his own name, he is personally liable to the third party. But if the third party comes to know the existence of the principal, he may hold either the agent or the principal or both of them liable.

5. **Where the agent acts for a principal who cannot be sued.** An agent is also presumed to incur personal liability where he contracts on behalf of a principal who, though disclosed, cannot be sued (Sec. 230). For example, where an agent acts for an ambassador or foreign sovereign, he is personally liable. Similarly, where promoters contract for a projected company, they are held personally liable for that, as the company, being non-existent at the time of the contract, cannot be sued.

6. **Where the agent exceeds his authority.** When an agent acts in excess of his real as well as apparent authority, and in this way commits a breach of warranty of authority, he will be personally liable to the third party for the excess part, if it can be separated from authorised part, otherwise for the whole transaction (Secs. 227 and 228).

7. **Where there is a trade usage or custom.** An agent also incurs personal liability where there is a trade usage or custom to that effect. For example, a jobber may hold a broker personally liable as per the custom of trade in a stock exchange.

8. **Where agent's authority is coupled with interest.** Where the contract with the third party relates to a subject-matter in which the agent has a special interest, agent is personally liable to the extent of his interest because he is really a principal for that interest.

It should be noticed that in *second, third, fifth* and *sixth* cases mentioned above, the third party can hold only the agent personally liable and not the principal.

TERMINATION OF AGENCY

An agency may be terminated in any of the following ways:

A. By act of the parties, or

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B. By operation of law.

We will consider these methods one after another.

A. Termination by Act of the Parties

An agency comes to an end by act of the parties in the following cases:

1. **Agreement.** An agency, like any other contract, can be terminated at any time by the mutual agreement between the principal and the agent.

2. **Revocation by the principal** (Secs. 203-207). Section 203 empowers the principal to revoke the authority of the agent at any time before the agent has exercised his authority so as to bind the principal, unless the agency is irrevocable.[21] Further, revocation may be expressed or implied in the conduct of the principal (Sec. 207). Thus where *A* empowers *B* to let *A*'s house and afterwards lets the house himself, it is an implied revocation of *B*'s authority. Revocation of authority by the principal is, however, subject to the following conditions:

(*i*) In the case of a continuous agency, the principal may revoke it for the future. It cannot be revoked with regard to acts already done in the agency. Again, before revoking the authority for the future, reasonable notice of the same should be given to the agent and also to third parties. If reasonable notice is not given, the principal will be liable to compensate the agent for damages resulting thereby (*i.e.,* for the agent's loss of salary if no immediate job is available), and be bound by the acts of the agent with respect to third parties. (Secs. 204 and 206).

(*ii*) Where an agency has been created for a fixed period and the principal revokes the authority of the agent before the expiry of the period, without sufficient cause, the principal is bound to pay compensation to the agent for the resulting loss, even if the authority is revoked after reasonable notice. (Sec. 205)

3. **Renunciation by the agent.** An agency may also be terminated by an express renunciation by the agent because a person cannot be compelled to continue as agent against his will. But he must give a reasonable notice of renunciation to the principal, otherwise he will be liable to compensate the principal for any damage resulting thereby (Sec. 206). If the agency is for a fixed period and the agent renounces it without sufficient cause before the expiry of the period, he shall have to compensate the principal for the resulting loss, if any (Sec. 205).

B. Termination by Operation of Law

An agency comes to an end automatically by operation of law in the following cases:

[21]See "*Irrevocable Agency*" heading in the following pages for the various cases in which an agency is said to be irrevocable.

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1. **Completion of the business of agency.** An agency automatically comes to an end when the business of agency is completed (Sec. 201). Thus, for example, an agency for the sale of a particular property terminates on the completion of the sale. Similarly, where a lawyer is appointed to plead in a suit, his authority comes to an end with the judgment.

2. **Expiry of time.** If the agent is appointed for a fixed term, the expiration of the term puts an end to the agency, even though the business of the agency may not have been completed.

3. **Death of the principal or the agent**. An agency is terminated automatically on the death of the principal or the agent (Sec. 201). After coming to know about the principal's death although the agency terminates but the agent must take all reasonable steps for the protection of the interests of the late principal entrusted to him (Sec. 209).

4. **Insanity of the principal or the agent.** An agency also stands terminated when the principal becomes of an unsound mind (Sec. 201). Here also it is the duty of an agent to protect the interests of the former principal by taking all reasonable steps (Sec. 209). Likewise when the agent becomes insane during the agency, his authority terminates at once and the agency comes to an end (Sec. 201). It is interesting to mention that a person of unsound mind can be initially appointed as an agent.

5. **Insolvency of the principal.** An agency is also terminated by the insolvency of the principal (Sec. 201). Whether the insolvency of an agent puts an end to the agency or not is a disputed question, Section 201 is silent on this point.

6. **Destruction of the subject-matter.** An agency which is created to deal with certain subject-matter will be terminated by the destruction of that subject-matter. For example, where the agency was created for the sale of a house and the house is destroyed by fire, the agency ends.

7. **Dissolution of a company.** If the principal or agent is an incorporated company, the agency automatically ceases to exist on dissolution of the company.

8. **Principal or agent becomes alien enemy.** If the principal and agent are nationals of two different countries and a war breaks out between the two countries, the contract of agency is terminated. The outbreak of war renders the continuance of the principal and agent relationship unlawful because now the principal or agent becomes an alien enemy.

When Termination of Agency Takes Effect

As between the principal and the agent, termination of agency is effective only when it becomes known to the agent, and so far as the third parties are concerned termination of agency takes effect when it is made known to them (Sec. 208). For example, in the case of termination of agency by

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revocation of agent's authority, the agency comes to an end as between the principal and the agent not from the moment of posting the letter of revocation, but from the time the agent receives the letter of revocation. Although after receiving the letter of revocation the agent's authority ends but he can still bind the principal towards third parties, if the third parties do not know the fact of the termination of agency. Thus the principal must also give a public notice regarding the fact of the termination of agency in order to make termination effective *vis-a-vis* third parties as well. Even when the agency is terminated automatically by the death, insanity or insolvency of the principal, knowledge of the agent is essential for completing termination as between him and the principal; and knowledge of third party is essential for making termination effective as between the third party and principal.

ILLUSTRATIONS (appended to Sec. 208). (*a*) *A* directs *B* to sell goods for him, and agrees to give *B* five per cent commission on the price fetched by the goods. *A* afterwards, by letter, revokes *B*'s authority. *B*, after the letter is sent, but before he receives it, sells the goods for Rs 100. The sale is binding on *A*, and *B* is entitled to five rupees as his commission.

(*b*) *A*, at Madras, by letter, directs *B* to sell for him some cotton lying in a warehouse in Bombay, and afterwards, by letter, revokes his authority to sell, and directs *B* to send the cotton to Madras. *B*, after receiving the second letter, enters into a contract with *C*, who knows of the first letter but not of the second, for the sale to him, of the cotton. *C* pays *B* the money with which *B* absconds. *C*'s payment is good as against *A*.

(*c*) *A* directs *B*, his agent, to pay certain money to *C*. *A* dies and *D* takes out probate of his 'will'. *B*, after *A*'s death but before hearing of it, pays the money to *C*. The payment is good as against *D*, the executor.

Irrevocable Agency

When the authority given to an agent cannot be revoked, it is said to be an irrevocable agency. An agency becomes irrevocable in the following cases:

1. **Where the agency is coupled with interest** (Sec. 202). Where the agent has himself an interest in the subject-matter of agency, the agency is said to be coupled with interest. Such an agency is created with the object of protecting or securing any interest of the agent. So where a creditor is employed for valuable consideration as an agent to collect rents due to the principal (debtor) for adjusting the amount towards his debt, the principal thereby confers an interest on the agent and the authority cannot be revoked unilaterally *during the subsistence of the interest,* in the absence of an express contract to the contrary.

It is important that the doctrine of agency coupled with interest applies only, if the authority was intended for the protection of an interest of the

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agent *existing at the time of the creation of the agency* and it is not sufficient that it does so incidentally. It, therefore, cannot apply where the interest arises after the creation of the agency.

It must also be noted that an agency coupled with interest is not terminated even by the death, insanity or insolvency of the principal.

ILLUSTRATIONS (appended to Sec. 202). (*a*) *A* gives authority to *B* to sell *A*'s land and to pay himself, out of the proceeds, the debts due to him from *A*. *A* cannot revoke this authority, nor can it be terminated by his insanity or death.

(*b*) *A* consigns 1,000 bales of cotton to *B*, who has made advances to him on such cotton, and desires *B* to sell the cotton, and to repay himself, out of the price, the amount of his own advances. *A* cannot revoke this authority, nor is it terminated by his insanity or death.

2. **When revocation would cause the agent personal loss.** Where the agent has, in pursuance of his authority, contracted a personal liability, the agency becomes irrevocable and the principal cannot revoke the authority unilaterally. This is so because the principal cannot be permitted to defeat rights already established.

ILLUSTRATIONS. (*a*) *A* authorises *B* to buy 1,000 bales of cotton on account of *A*, and to pay for it out of *A*'s money remaining in *B's* hands. *B* buys 1,000 bales of cotton in his own name so as to make himself personally liable for the price. *A* cannot revoke *B's* authority so far as regards payment for the cotton. [Illustration (*a*) appended to Section 204].

(*b*) *A* gives authority to *B* to pay *A*'s creditor *C* and places the necessary money in the hands of *B* for that purpose. Thereupon *B* informs *C* that he has received money in his hands for payment of his debt and that *C* may collect the same any time from him. *A* cannot revoke *B*'s authority to pay to *C* as *B* has incurred a personal liability.

3. **When the authority has been partly exercised by the agent** (Sec. 204). Where the agent has partly exercised his authority, it becomes irrevocable so far as regards such acts and obligations as arise from acts already done in the agency.

ILLUSTRATION (appended to Sec. 204). *A* authorises *B* to buy 1,000 bales of cotton on account of *A*, and to pay for it out of *A's* money remaining in *B*'s hands. *B* buys 1,000 bales of cotton in *A*'s name and so as not to render himself personally liable for the price. *A* cannot revoke *B*'s authority so far as regards buying the cotton but can revoke *B's* authority to pay for the cotton.

TEST QUESTIONS

1. Define the terms "agent" and "principal". Discuss the general rules of agency. What is the test of agency? Is consideration necessary to create an agency?
2. Who is an agent? How does he differ from a servant? Can a minor (*i*) appoint an agent, (*ii*) be appointed an agent?
3. What is a contract of agency? What are the different kinds of agents?
4. Briefly explain the various modes by which an agency may be created.

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5. What is agency by ratification? What are the requisites of a valid ratification?

6. Define "actual authority" and "ostensible authority" of an agent and explain the extent of an agent's authority. Can an agent delegate his authority to another? If so, under what circumstances?

7. Who is a sub-agent? What are the consequences of the appointment of a sub-agent? Distinguish between a sub-agent and a substituted agent.

8. Briefly explain the duties of an agent towards his principal. What are his rights against the principal?

9. Discuss fully the extent of principal's liability to third parties for the acts of the agent.

10. Explain the effect of a contract made by an agent with a third party when he acts for; (a) an unnamed principal, *(b)* an undisclosed principal.

11. 'The law which superadds the liability of an agent does not detract from the liability of the principal,' Examine the statement, pointing out the circumstances in which the agent is presumed to be personally liable for the contracts entered into by him on behalf of the principal.

12. Describe briefly the various modes by which an agency may be terminated. When is agency irrevocable?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* enters into a contract with *B* for buying *B*'s motor car as agent of *C* and without *C*'s authority. *B* repudiates the contract before *C* comes to know of it. *C* subsequently ratifies and contract and sues to enforce it. How would you decide?

[**Hint**. *C* is entitled to enforce the contract or claim damages. It is a case of agency by ratification, where the agency comes into existence from the moment the agent acted and not from the time when the principal ratified. Hence *B*'s repudiation of the contract is inoperative. (*Bolton* vs *Lambert*)]

2. A policeman, thinking that the driver of an omnibus was drunk, ordered him to discontinue driving, the omnibus being then only a quarter of a mile from its destination. The driver and the conductor then authorised a person standing nearby to drive the omnibus home. That person drove the omnibus negligently and injured a boy. The boy claims damages from the owners of the omnibus. Are the owners liable?

[**Hint** The owners are not liable to the boy. It is not a case of agency by necessity (which does not arise if the agent can communicate with his principal) because the owners were only a quarter of a mile away and might have been easily communicated with. There was thus no necessity for the driver and conductor to employ another person.]

3. *A* enters into a contract with *B* to sell him 1,000 bales of cotton and afterwards discovers that *B* was acting as agent of *C*. Advise *A* as to the person against whom he should bring a suit for the price of the cotton.

[**Hint**. *A* may sue either *B* or *C* or both, for the price of the cotton. It is a case of undisclosed principal and the liability of the principal and agent is "joint and several" in such a case (Sec. 233).]

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4. *A* employs *P* as his agent for selling his (*A*'s) watch. *P* is instructed to sell the watch for not less than Rs 80. *P* buys the watch himself and hands over Rs 80 to *A*, who is quite satisfied with the price and does not ask the name of the buyer. *A* discovers the identity of the buyer a few weeks later after *P* has resold the watch for Rs 100. Can *A* claim Rs 20 from *P*?

[Hint. No, *A* cannot claim Rs 20 from *P*. According to Sections 215 and 216 of the Contract Act, if the dealings of the agent have not been *disadvantageous* to the principal, he cannot claim the profit made on subsequent sale by the agent, even though the agent dealt on his own account without first obtaining the consent of the principal.]

5. An agent, authorised by a power of attorney to operate a business but not to borrow money, asked for a loan on a representation that he is authorised to borrow and produced the power of attorney for the perusal of the lender. But the lender did not read it and advanced a loan. Is the principal bound by the loan?

[Hint. No, the principal is not bound by the loan because the borrowing by the agent, in the instant case, does not come within his ostensible authority. As the power of attorney was produced for the perusal of the lender, he had constructive notice that the agent had no power to borrow, and therefore he is bound by the restriction on the agent's ostensible authority and cannot recover the loan from the principal (*Jacobs* vs *Morris,* 1902, 1 Ch. 816).]

6. *A*, who owes *B* Rs 10,000, appoints *B* as his agent to sell his landed property at Delhi and after paying himself (*B*) what is due to him, to hand over the balance to *A*. Can *A* revoke his authority delegated to *B*?

[Hint. No, *A* cannot revoke the authority delegated to *B*. The doctrine of agency coupled with interest applies in the instant case.]

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PART II

Law of Sale of Goods

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Chapter 16

Contract of Sale of Goods

The law relating to sale of goods is contained in the Sale of Goods Act, 1930,[1] which came into force on 1st July 1930. The Act contains sixty-six Sections and extends to the whole of India except the State of Jammu and Kashmir. A few minor amendments in the Act were made by Sale of Goods (Amendment) Act, 1963.

The general provisions of the Indian Contract Act continue to be applicable to the contract of sale of goods in so far as they are not inconsistent with the express provisions of Sale of Goods Act (Sec. 3). Thus, for example, the provisions of the Contract Act relating to capacity of the parties, free consent, agreements in restraint of trade, wagering agreements and measure of damages continue to be applicable to a contract of sale of goods. But the definition of consideration stands modified to the extent that in a contract of sale of goods consideration must be by way of 'price,' *i.e.,* only money consideration [Secs. 2(10) and 4].

A contract of sale of goods results, like any other contract, by an offer by one party and its acceptance by the other. Thus, it is a consensual transaction. The parties to the contract enjoy unfettered discretion to agree to any terms they like relating to delivery and payment of price, etc. The Sale of Goods Act does not seek to fetter this discretion. It simply lays down certain positive rules of general application for those cases where the parties have failed to contemplate expressly for contingencies which may interrupt the smooth performance of a contract of sale, such as the destruction of the thing sold, before it is delivered or the insolvency of the buyer, etc. The Act leaves the parties free to modify the provisions of the law by express stipulations.

Definition and Essentials of a Contract of Sale

Section 4(1) of the Sale of Goods Act defines a contract of sale of

[1]Throughout Part II of this book (*i.e.*, Chapters 16-20), which deals with the Law of Sale of Goods, the references to Sections, unless otherwise specifically stated, are references to Sections of the Sale of Goods Act, 1930. The word 'Act' wherever used means the Sale of Goods Act, 1930.

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goods as—"a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price."

This definition reveals the following essential characteristics of a contract of sale of goods:

1. **Two parties.** The first essential is that there must be two distinct parties to a contract of sale, *viz.*, a buyer and a seller, as a person cannot buy his own goods. Thus, for example, when students of a hostel take meals with a mess run by themselves on cooperative lines, there is no contract of sale. The students are 'undivided joint owners' of the meals they are consuming. As a matter of fact every member of the mess is consuming his own goods on the basis of understanding that he must restore to the mess what he consumed so that the mess continue to provide meals for its members. An 'undivided joint owner' must be distinguished from a 'part-owner' who is a joint owner with divisible share. According to Section 4(1), there may be a contract of sale between one part-owner and another, *e.g.*, if *A* and *B* jointly own a typewriter, *A* may sell his ownership in the typewriter to *B*, thereby making *B* sole owner of the goods. Similarly, a partner may buy the goods from the firm in which he is a partner and *vice-versa.* There is, however, one exceptional case when a person may buy his own goods. Where a person's goods are sold in execution of a decree, he may himself buy them, so as to save them from a transfer of ownership to some one else (*Moore* vs *Singer Manufacturing Co.*[2]).

2. **Transfer of property.** 'Property' here means 'ownership'. Transfer of property in the goods is another essential of a contract of sale of goods. A mere transfer of possession of the goods cannot be termed as sale. To constitute a contract of sale the seller must either transfer or agree to transfer the property in the goods to the buyer. Further, the term 'property,' as used in the Sale of Goods Act, means 'general property' in goods as distinguished from 'special property' [Sec. 2(11)]. If *P* who owns certain goods pledges them to *R,* he has general property in the goods, whereas *R* (the Pawnee) has special property or interest in the goods to the extent of the amount of advance he has made to the pawnor. Similarly, in the case of bailment of goods for the purpose of repair, the bailee has special interest in goods bailed to the extent of his labour charges.

3. **Goods.** The subject-matter of the contract of sale must be 'goods', According to Section 2(7), "*goods* means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale."

Thus every kind of movable property except actionable claim and

[2](1904), 1 K.B. 820 (C.A.).

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money is regarded as 'goods'. Goodwill, trade marks, copyrights, patents right, water, gas, electricity,[3] decree of a court of law,[4] are all regarded as goods. Shares and stock are also included in goods. With regard to growing crops, grass and things attached to or forming part of the land, such things are regarded as goods as soon as they are agreed to be separated from the land. Thus where trees were sold so that they could be cut out and separated from the land and then taken away by the buyer, it was held that there was a contract for sale of movable property or goods (*Kursell* vs *Timber Operators & Contractors Ltd.*[5]). But contracts for sale of things 'forming part of the land itself' are not contracts for sale of goods. For example, a contract for the sale of coal mine or building-stone quarry is not a contract of sale of goods.

'Actionable claims' means claims which can be enforced by a legal action or a suit, *e.g.,* a book debt (*i.e.*, a debt evidenced by an entry by the creditor in his Account Book or *Bahi*). A book debt is not goods because it can only be assigned as per the Transfer of Property Act but cannot be sold. Similarly, a bill of exchange or a promissory note represents a debt, *i.e.*, an actionable claim and implies the right of the creditor to recover its amount from the debtor. But since these can be transferred under Negotiable Instruments Act by mere delivery *or* indorsement and delivery, such instruments cannot be sold.

'Money' means current money. It is not regarded goods because it is the medium of exchange through which goods can be bought. Old and rare coins, however, may be treated as goods and sold as such.

It may be mentioned that sale of immovable property is governed by the Transfer of Property Act, 1882.

4. **Price.** The consideration for a contract of sale must be money consideration called the 'price.' If goods are sold or exchanged for other goods, the transaction is barter, governed by the Transfer of Property Act and not a sale of goods under this Act. But if goods are sold partly for goods and partly for money, the contract is one of sale (*Aldridge* vs *Johnson*[6]).

5. **Includes both a 'sale' and 'an agreement to sell.'** The term 'contract of sale' is a generic term and includes both a 'sale' and an 'agreement to sell' [as is clear from the definition of the term as per Section 4(1) given earlier].

Sale. Where under a contract of sale the property in the goods is immediately transferred at the time of making the contract from the seller

[3]*Rash Behari* vs *Emperor,* A.I.R. (1936), Cal. 753.
[4]*Vithaldas* vs *Jagjivan,* A.I.R. (1939), Bom. 84.
[5](1927), 1 K.B. 298.
[6](1857), 7 E. & B. 885.

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to the buyer,[7] the contract is called a 'sale' [Sec. 4(3)]. It refers to an 'absolute sale', *e.g.,* an outright sale on a counter in a shop. There is immediate conveyance of the ownership and mostly of the subject-matter of the sale as well (delivery may also be given in future). It is an *executed* contract.

An agreement to sell. Where under a contract of sale the transfer of property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, the contract is called 'an agreement to sell' [Sec. 4(3)]. It is an *executory* contract and refers to a conditional sale.

ILLUSTRATIONS. *(a)* On 1 January, *A* agrees with *B* that he will sell *B* his scooter on 15 January for a sum of Rs 3,000. It is an agreement to sell, since *A* agrees to transfer the ownership of the scooter to *B* at a future time.

(b) A agrees to purchase *B*'s car for Rs 50,000 provided *B* stands surety for him with *C*. It is an agreement to sell for *B*. It becomes a sale when the condition is fulfilled by *B*.

(c) B agrees to buy *A*'s car for Rs 30,000 and pay for it, if his solicitor approves. It is an agreement to sell for *A* and an agreement to buy for *B*.

(d) A buys some furniture for Rs 2,000 and agrees to pay for that in two monthly instalments, the ownership to pass to him on the payment of second instalment. There is an agreement to sell for the furniture dealer.

'An agreement to sell' becomes a 'sale' when the time elapses or the conditions are fulfilled subject to which the property in the goods is to be transferred [Sec. 4 (4)].

6. **No formalities to be observed** (Sec. 5). The Sale of Goods Act does not prescribe any particular form to constitute a valid contract of sale. A contract of sale of goods can be made by mere offer and acceptance. The offer may be made either by the seller or the buyer and the same must be accepted by the other. Neither payment nor delivery is necessary at the time of making the contract of sale. Further, such a contract may be made either orally or in writing or partly orally and partly in writing or may be even implied from the conduct of the parties. Where articles are exhibited for sale and a customer picks up one and the sales assistant packs the same for him, there has resulted a contract of sale of goods by the conduct of the parties.

'Sale' and 'Agreement to Sell' Distinguished

The following are the main points of distinction between a 'sale' and 'an agreement to sell':

1. **Transfer of property (ownership).** In a 'sale' the property in goods passes to the buyer immediately at the time of making the contract. In other

[7]The rules regarding 'transfer of property from seller to buyer' form the subject-matter of Ch. 18—*Transfer of Property.*

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words, a sale implies immediate conveyance of property so that the seller ceases to be the owner of the goods and the buyer becomes the owner thereof. It creates a *jus in rem, i.e.,* gives right to the buyer to enjoy goods as against the whole world.

In 'an agreement to sell' there is no transfer of property to the buyer at the time of the contract. The conveyance of property takes place later so that the seller continues to be the owner until the agreement to sell becomes a sale either by the expiry of certain time or the fulfilment of some condition. Thus where *A* agrees to buy 50 kg wheat from *B* and the wheat is yet to be weighed, the transaction is an agreement to sell because as per Section 22, in such a case the property does not pass to the buyer till the goods are weighed and the buyer has notice thereof. The transaction becomes a sale and the property in the goods passes to the buyer after the wheat is weighed and the buyer has notice thereof. An agreement to sell creates a *jus in personam,* that is, it gives a right to either buyer or seller against the other for any default in fulfilling his part of the agreement.

It is worth noting that this is the basic point of distinction between a 'sale' and 'an agreement to sell.' All other points of distinction follow from this basic difference, *i.e.,* whether the property in the goods has passed or is yet to pass from seller to buyer.

2. **Risk of loss.** The general rule is that unless otherwise agreed, the risk of loss *prima facie* passes with property (Sec. 26). Thus in case of sale, if the goods are destroyed the loss falls on the buyer even though the goods may never have come into his possession because the property in the goods has already passed to the buyer. On the other hand, in case of an agreement to sell where the ownership in the goods is yet to pass from the seller to the buyer, such loss has to be borne by the seller even though the goods are in the possession of the buyer.

3. **Consequences of breach.** In case of sale, if the buyer wrongfully neglects or refuses to pay the price of the goods, the seller can sue for the price, even though the goods are still in his possession. In case of an agreement to sell, if the buyer fails to accept and pay for the goods, the seller can only sue for damages and not for the price, even though the goods are in the possession of buyer.

4. **Right of resale.** In a sale, the property is with the buyer and as such the seller (in possession of goods after sale) cannot resell the goods. If he does so, the subsequent buyer having knowledge of the previous sale does not acquire a title to the goods. The original buyer can sue and recover the goods from the third person as owner, and can also sue the seller for the breach of contract as well as for the tort of conversion. The right to recover the goods from the third person is, however, lost if the subsequent buyer had bought them *bonafide* without notice of the previous sale (Sec. 30).

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In an agreement to sell, the property in the goods remains with the seller and as such he can dispose of the goods as he likes and the original buyer can sue him for the breach of contract only. In this case, the subsequent buyer gets a good title to the goods, irrespective of his knowledge of previous sale. Further, goods forming the subject-matter of an agreement to sell can also be attached in execution of a decree of a court of law against the seller.

5. **Insolvency of buyer before he pays for the goods.** In a sale, if the buyer is adjudged insolvent before he pays for the goods, the seller, in the absence of a 'right of lien' over the goods, must deliver the goods to the Official Receiver or Assignee. The seller is entitled only to a rateable dividend for the price of the goods. But in an agreement to sell, in these circumstances, the seller may refuse to deliver the goods to the Official Receiver or Assignee unless paid for, as ownership has not passed to the buyer.

6. **Insolvency of seller if the buyer has already paid the price.** In a sale, if the seller is adjudged insolvent, the buyer is entitled to recover the goods from the Official Receiver or Assignee, as the property in the goods rests with the buyer. On the other hand, in an agreement to sell, if the buyer has already paid the price and the seller is adjudged insolvent, the buyer can only claim a rateable dividend (as a creditor) and not the goods because property in them still rests with the seller.

Sale Distinguished from Hire Purchase

Contracts of sale resemble contracts of hire purchase very closely, and indeed the real object of a contract of hire purchase is the sale of the goods ultimately. Nonetheless a sale has to be distinguished from a hire purchase as their legal incidents are quite different. Under hire purchase agreement the goods are delivered to the hire purchaser for his use at the time of the agreement but the owner of the goods agrees to transfer the property in the goods to the hire purchaser only when a certain fixed number of instalments of price are paid by the hirer. Till that time, the hirer remains the bailee and the instalments paid by him are regarded as the hire-charges for the use of the goods. If there is a default by the hire purchaser in paying an instalment, the owner has a right to resume the possession of the goods immediately without refunding the amount received till then, because the ownership still rests with him. Thus, the essence of hire-purchase agreement is that there is no agreement to buy, but there is only a bailment of the goods coupled with an option to purchase them which may or may not be exercised.

It may be noted that mere payment of price by instalments under an agreement does not necessarily make it a hire-purchase, but it may be a

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sale. For example, in the case of "Instalment Purchase Method," there is a 'sale,' because in this case the buyer is bound to buy with no option to return and the property in goods passes to the buyer at once.

The main points of distinction between the 'sale' and 'hire-purchase' are as follows:

1. In a sale, property in the goods is transferred to the buyer immediately at the time of contract, whereas in hire-purchase the property in the goods passes to the hirer upon payment of the last instalment.

2. In a sale the position of the buyer is that of the owner of the goods but in hire purchase the position of the hirer is that of a bailee till he pays the last instalment.

3. In the case of a sale, the buyer cannot terminate the contract and is bound to pay the price of the goods. On the other hand, in the case of hire-purchase the hirer may, if he so likes, terminate the contract by returning the goods to its owner without any liability to pay the remaining instalments.

4. In the case of a sale, the seller takes the risk of any loss resulting from the insolvency of the buyer. In the case of hire purchase, the owner takes no such risk, for if the hirer fails to pay an instalment the owner has the right to take back the goods.

5. In the case of a sale, the buyer can pass a good title to a *bonafide* purchaser from him but in a hire-purchase, the hirer cannot pass any title even to a *bonafide* purchaser.

6. In a sale, sales tax is levied at the time of the contract whereas in a hire-purchase sales tax is not leviable until it eventually ripens into a sale (*K.L. Johar & Co.* vs *Dy. Commercial Tax Officer*[8]).

Hire-purchase and an agreement to sell. A contract of hire-purchase may also be distinguished from "an agreement to sell" (or "an agreement to buy" from buyer's point of view). As already observed, a hire-purchase agreement initially is merely an *irrevocable offer* for sale, that is, under it the owner is bound to sell the goods later if the hirer pays all the instalments as agreed, but on the part of the hire purchaser there is an option to buy or to return the goods and the hirer cannot be compelled to buy. 'An agreement to buy', on the other hand, imports a legal obligation to buy and therefore there is no option available to the buyer to buy or to terminate the contract in this case. Again, in a hire-purchase agreement, delivery of goods to the hire-purchaser is necessary whereas it is not so in an 'agreement to sell.'

Sale Distinguished from Contract for Work and Labour

A distinction has to be made between a contract of sale and a contract

[8]A.I.R. (1965), S.C. 1082.

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for work and labour mainly because of taxation purpose. Sales tax is levied only in the case of a contract of sale. When property in the goods is intended to be transferred and goods are ultimately to be delivered to the buyer, it is a contract of sale even though some labour on the part of the seller of the goods may be necessary. Where, however, the essence of the contract is rendering of service and exercise of skill and no goods are delivered as such, it is a contract of work and labour and not of sale. In fact, the difference between the two is very minute.

ILLUSTRATIONS. *(a)* A dentist agreed to make a set of false teeth for a lady and fit it into her mouth. *Held,* it is a contract for the sale of goods (*Lee* vs *Griffin*[9]).

(b) An order for making and fixing curtains in a house is a contract of sale of goods, though it involves some work and labour in fixing the same (*Love* vs *Norman Wright (Builders) Ltd.*[10]).

(c) *G* engaged an artist to paint a portrait and supplied the necessary canvas and paint. *Held,* it is a contract for work and labour as the substance of the contract is the application of the skill and labour in the production of the portrait (*Robinson* vs *Graves*[11]). If the canvas and paint are also to be supplied by the painter, it will become a contract of sale of goods.

(d) A contract to take and supply photographs has been held to be a contract of sale of goods (*Newman* vs *Lipman*[12]).

Kinds of Goods

'Goods' form the subject-matter of a contract of sale. We have already seen the meaning of the term 'goods' as per Section 2(7). Goods may be classified into the following types:

1. Existing goods;
2. Future goods; and
3. Contingent goods.

1. **Existing goods.** Goods which are physically in existence and which are in seller's ownership and/or possession, at the time of entering the contract of sale are called 'existing goods.' Where seller is the owner, he has the general property in them. Where seller is in possession, say, as an agent or a pledgee, he has a right to sell them.

Existing goods may again be either 'specific' or 'unascertained.'

(a) Specific goods. Goods identified and agreed upon at the time of the making of the contract of sale are called 'specific goods' [Sec. 2(14)]. It may be noted that in actual practice the term 'ascertained goods' is used

[9](1861), 1 B. & S. 272.
[10](1944), All. E.R.618.
[11](1935), 1 K.B. 579.
[12](1951), 1 K.B. 333.

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in the same sense as 'specific goods.' For example, where *A* agrees to sell to *B* a particular radio bearing a distinctive number, there is a contract of sale of specific or ascertained goods.

(b) Unascertained goods. The goods which are not separately identified or ascertained at the time of the making of the contract are known as 'unascertained goods.' They are indicated or defined only by description. For example, if *A* agrees to sell to *B* one bag of sugar out of the lot of one hundred bags lying in his godown, it is a sale of unascertained goods because it is not known which bag is to be delivered. As soon as a particular bag is separated from the lot for delivery, it becomes ascertained or specific goods.

The distinction between 'specific' or 'ascertained' and 'unascertained' goods is important in connection with the rules regarding 'transfer of property' from the seller to the buyer. These rules will be discussed later in Chapter 18—*Transfer of Property.*

2. Future goods. Goods to be manufactured, produced or acquired by the seller after the making of the contract of sale are called 'future goods' [Sec. 2(6)]. These goods may be either not yet in existence or be in existence but not yet acquired by the seller. It is worth noting that there can be no present sale of future goods because property cannot pass in what is not owned by the seller at the time of the contract. So even if the parties purport to effect a present sale of future goods, in law it operates only as an 'agreement to sell' [Sec. 6(3)].

ILLUSTRATIONS. *(a) A* agrees to sell to *B* all the milk that his cow may yield during the coming year. This is a contract for the sale of future goods.

(b) X agrees to sell to *Y* all the mangoes which will be produced in his garden next year. It is contract of sale of future goods, amounting to 'an agreement to sell.'

(c) P contracts on 1 January 1990, to sell to *B* ten bales of Egyptian cotton to be delivered and paid for on 1 March, 1990. This is a valid contract of sale, amounting to 'an agreement to sell,' even though *P* has no cotton bales with him at the time of making the contract.

3. Contingent goods. Goods, the acquisition of which by the seller depends upon an uncertain contingency are called 'contingent goods' [Sec. 6(2)]. Obviously they are a type of future goods and therefore a contract for the sale of contingent goods also operates as 'an agreement to sell' and not a 'sale' so far as the question of passing of property to the buyer is concerned. In other words, like the future goods, in the case of contingent goods also the property does not pass to the buyer at the time of making the contract. It is important to note that a contract of sale of contingent goods is enforceable only if the event on the happening of which the performance of the contract is dependent happens, otherwise the contract becomes void.

ILLUSTRATIONS. *(a) A* agrees to sell to *B* a specific rare painting provided

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he is able to purchase it from its present owner. This is a contract for the sale of contingent goods.

(b) *X* agrees to sell to *Y* 25 bales of Egyptian cotton, provided the ship which is bringing them reaches the port safely. It is a contract for the sale of contingent goods. If the ship is sunk, the contract becomes void and the seller is not liable.

Effect of Perishing of Goods

Sections 7 and 8 deal with the effect of perishing of goods on the rights and obligations of the parties to a contract of sale. Under these Sections the word 'perishing' means not only physical destruction of the goods but it also covers:

(a) damage to goods so that the goods have ceased to exist in the commercial sense, *i.e.*, their merchantable character as such has been lost (although they are not physically destroyed), *e.g.*, where cement is spoiled by water and becomes almost stone or where sugar becomes sharbat and thus are unsaleable as cement or sugar;

(b) loss of goods by theft (*Barrow Ltd.* vs *Phillips Ltd.*[13]);

(c) where the goods have been lawfully requisitioned by the government (*Re Shipton, Anderson & Co.*[14]).

It may also be mentioned that it is only the perishing of *specific and ascertained goods* that affects a contract of sale. Where, therefore, *unascertained goods* form the subject-matter of a contract of sale, their perishing does not affect the contract and the seller is bound to supply the goods from wherever he likes, otherwise be liable for breach of contract. Thus where *A* agrees to sell to *B* ten bales of Egyptian cotton out of 100 bales lying in his godown and the bales in the godown are completely destroyed by fire, the contract does not become void. *A* must supply ten bales of cotton after purchasing them from the market or pay damages for the breach.

The effect of perishing of goods may be discussed under the following heads:

1. **Perishing of goods at or before making of the contract** (Sec. 7). This may again be divided into the following sub-heads:

(i) *In case of perishing of the 'whole' of the goods.* Where *specific goods* from the subject-matter of a contract of sale (both actual sale and agreement to sell), and they, without the knowledge of the seller, perish, at or before the time of the contract, the contract is void. This provision is based either on the ground of mutual mistake as to a matter of fact essential to the agreement, or on the ground of impossibility of performance, both of which render an agreement void *ab-initio.*

ILLUSTRATIONS. *(a)* *A* sold to *B* a specific cargo of goods supposed to be

[13](1929), 1 K.B. 574.

[14](1915), 3 K.B. 676.

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on its way from England to Bombay. It turned out, however, that before the day of the bargain, the ship conveying the cargo had been cast away and the goods were lost. Neither party was aware of the fact. The agreement was held to be void (*Hastie* vs *Conturier*[15]).

(b) A agrees to sell to *B* a certain horse. It turns out that the horse was dead at the time of bargain, though neither party was aware of the fact. The agreement is void.

(ii) In case of perishing of only 'a part' of the goods. Where in a contract for the sale of *specific goods,* only *part* of the goods are destroyed or damaged, the effect of perishing will depend upon whether the contract is entire or divisible. If it is entire (*i.e.*, indivisible) and part only of the goods has perished, the contract is void. If the contract is divisible, it will not be void and the part available in good condition must be accepted by the buyer.

ILLUSTRATION. There was a contract for the sale of a parcel containing 700 bags of Chinese groundnuts of different qualities. Unknown to the seller 109 bags had been stolen at the time of the contract. The seller delivered the remaining 591 bags and, on the buyer's refusal to take them, brought an action for the price. It was held that the contract, being indivisible, had become void by reason of the loss of the goods and the buyer was not bound to take delivery of 591 bags or pay for the goods (*Barrow Ltd* vs *Philips Ltd*[16]). (Note that had there been all bags of the same weight and quality for certain price per bag, the contract would have been divisible and the buyer could only have avoided the contract as to those goods which had actually perished).

2. **Perishing of goods before sale but after agreement to sell** (Sec. 8). Where there is an agreement to sell specific goods, and subsequently the goods, without any fault on the part of the seller or buyer, perish before the risk passes to the buyer, the agreement is thereby avoided, *i.e.*, the contract of sale becomes void and both parties are excused from performance of the contract. This provision is based on the ground of supervening impossibility of performance which makes a contract void. Notice that under Section 7 the agreement is void *ab-initio* while under this Section the contract becomes void later.

If only *part* of the goods agreed to be sold perish, the contract becomes void if it is indivisible. But if it is divisible then the parties are absolved from their obligations only to the extent of the perishing of the goods (*i.e.*, the contract remains valid as regards the part available in good condition).

It must further be noted that if fault of either party causes the destruction of the goods, then the party in default is liable for non-delivery or to pay for the goods, as the case may be (Sec. 26). Again, if the risk has

[15](1853), 5 H.L. Cas. 673.
[16](1929), 1 K.B. 574.

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passed to the buyer, he must pay for the goods, though undelivered [unless otherwise agreed... risk *prima facie* passes with the property (Sec. 26)].

ILLUSTRATIONS. *(a)* A buyer took a horse on a trial for 8 days on condition that if found suitable for his purpose the bargain would become absolute. The horse died on the 3rd day without any fault of either party. *Held,* the contract, which was in the form of an agreement to sell, becomes void and the seller should bear the loss (*Elphick* vs *Barnes*[17]).

(b) A, had contracted to erect machinery on *M's* premises, the price was to be paid on completion. During the course of the work, there was a fire which completely destroyed the premises and the machinery. It was held that both parties were excused from further performance and *A* was not entitled to any payment as the price was payable on the completion of entire work (*Appleby* vs *Myers.*[18]).

Effect of perishing of future goods. As observed earlier, a present sale of future goods always operates as an agreement to sell [Sec. 6(3)]. As such there arises a question as to whether Section 8 applies to a contract of sale of future goods (amounting to an agreement to sell) as well? The answer is found in the leading case of *Howell* vs *Coupland,*[19] where it has been held that future goods, if sufficiently identified, are to be treated as specific goods, the destruction of which makes the contract void. The facts of the case are as follows:

ILLUSTRATION. *C* agreed to sell to *H* 200 tons of potatoes to be grown on *C*'s land. *C* sowed sufficient land to grow the required quantity of potatoes, but without any fault on his part, a disease attacked the crop and he could deliver only about ten tons. The contract was held to have become void.

The Price

The money consideration for a sale of goods is known as 'price' [Sec. 2(10)]. We have already seen that the price is an essential element in every contract of sale of goods, that is, no valid sale can take place without a price. The price should be paid or promised to be paid in legal tender money, unless otherwise agreed. It may be paid in the form of a cheque, hundi, bank deposit etc. For, it is not the mode of payment of a price but the agreement to pay a price in money that is requisite to constitute a valid contract of sale.

Modes of fixing the price. According to Section 9 the price may be fixed by one or the other of the following modes:

1. *It may be expressly fixed by the contract itself.* This is the most usual mode of fixing the price. The parties are free to fix any price they like and the court will not question as to the adequacy of price. But the sum

[17](1880), 5 C.P.D. 321.
[18](1867), L.R. 2 C.P. 651.
[19](1876), 1 Q.B.D. 258.

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should be definite. Where an alternative price is fixed, the agreement is void *ab-initio* as it involves an element of wager (*Bourke* vs *Short*[20]).

2. *It may be fixed in accordance with an agreed manner provided by the contract.* For example, it may be agreed that the buyer would pay the market price prevailing on a particular date, or that the price is to be fixed by a third party (*i.e.*, valuer) appointed by the consent of the parties. But in the following cases where the agreement of the parties as to price is uncertain, price is deemed as 'not capable of being fixed' and hence the agreement is void *ab-initio* for uncertainty:

(a) if the price is agreed to be whatever sum the seller be offered by any third party; or

(b) if the price is left to be fixed by one of the contracting parties, expressly.

Remember that if no price is fixed then the contract is not void for uncertainty because in that case law usually allows market price prevailing on the date of the supply of goods as the price bargained for.

3. *It may be determined by the course of dealings between the parties.* For example, if the buyer has been previously paying to a particular seller the price prevailing on the date of placing the order, the course of dealings suggest that in subsequent transactions also the price as on the date of order will be paid.

4. *If the price is not capable of being determined in accordance with any of the above modes, the buyer is bound to pay to the seller a 'reasonable price.'* What is a reasonable price is a question of fact dependent on the circumstances of each particular case. Ordinarily, the market price of the goods prevailing on the date of supply is taken as reasonable price.

Agreement to sell at valuation (Sec. 10). Where there is an agreement to sell goods on the terms that the price is to be fixed by the valuation of a third party and such third party fails to fix the price (either because he cannot value or because he does not want to value), the contract becomes void, except as to part of goods delivered and accepted, if any, under the contract, as regards which the buyer is bound to pay a reasonable price. If, however, any one of the two parties, namely, the seller or the buyer, prevents the third party from making the valuation, the innocent party may maintain a suit for damages against the party in fault. Notice that although in this case also the contract becomes void, yet the party at fault is bound to compensate the other party for the actual loss suffered by him because of the act of prevention.

It is to be remembered that unless otherwise agreed, payment of the price and delivery of the goods are concurrent conditions (Sec. 32). Again,

[20](1856), 5 El. & Bl. 904.

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Section 64-A, which provides for "Escalation Clause," is important. As per Section 64-A, unless otherwise agreed, where, after making of the contract and fixing the price but before the delivery of the goods, a new or increased custom or excise duty or sale or purchase tax is imposed and the seller has to pay it, the seller is entitled to add the same to the price. Conversely, if the rate of duty or tax is lowered, the buyer would be entitled to a reduction in price.

Earnest or Deposit

Money deposited with the seller by the buyer as security for due fulfilment of the contract is called 'earnest' or 'deposit'. Where the contract is carried through, earnest money counts as part payment and only the balance of the price is required to be paid. But if the contract goes off because of the fault of the buyer, the seller is entitled to forfeit it and where it falls through because of the default of the seller, the buyer is entitled to recover the earnest money in addition to damages for breach. If on the breach of the agreement by the buyer, the seller sues him for the breach, the earnest, although forfeited, is to be taken into account as diminishing the amount of damages (*Jaganadhayya* vs *Ramanatha*[21]).

Stipulations as to Time

Stipulations as to time in a contract of sale fall under the following two heads:

1. Stipulation relating to time of delivery of goods.
2. Stipulation relating to time of payment of the price.

As regards the time fixed for the delivery of goods, time is usually held 'to be of the essence of the contract.' Thus if time is fixed for the delivery of goods and the seller makes a delay, the contract is voidable at the option of the buyer. In case of late delivery, therefore, the buyer may refuse to accept the delivery and may put an end to the contract.

As regards the time fixed for the payment of the price, the general rule is that 'time is not deemed to be of the essence of the contract,' unless a different intention appears from the terms of the contract (Sec. 11). Thus even if the price is not paid as agreed, the seller cannot avoid the contract on that account. He has to deliver the goods if the buyer tenders the price within reasonable time before resale of the goods. The seller may, however, claim compensation for the loss occasioned to him by the buyer's failure to pay on the appointed day.

[21]A.I.R. (1955), Orissa 11.

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Document of Title to Goods

Any document which is used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorise, either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented is a document of title to goods [Sec. 2(4)]. Thus a document of title is a proof of the ownership of the goods. It authorises its holder to receive goods mentioned therein or to further transfer such right to another person by proper endorsement or delivery.

A document of title to goods contains an undertaking on the part of the issuing authority to deliver the goods to the holder thereof unconditionally. Although such a document can be transferred by mere delivery or by endorsement, yet it is regarded as 'quasi negotiable instrument' because the title of the transferee (even if *bonafide*) will not be superior to that of the transferor in the case of transfer of such document.

Bill of lading, dock-warrant, warehouse keeper's certificate, wharfinger's certificate, railway receipt, delivery order, *etc.*, are popular examples of the documents of title to goods.

TEST QUESTIONS

1. What is a contract of sale of goods? Discuss the essential characteristics of a contract of sale of goods.
2. Define the term 'sale' and 'agreement to sell' and distinguish between the two. Give examples.
3. *(a)* 'The contract of sale is consensual and bilateral.' Elucidate.
   (b) Distinguish between 'sale' and 'agreement to sell.'
4. How would you distinguish between *(a)* a sale and hire purchase, and *(b)* a sale and a contract for work and labour.
5. Define the term 'goods'. What are the different types of goods?
6. What is the meaning of 'perishing' of goods under the Sale of Goods Act? What is the effect of perishing of goods on a contract of sale?
7. Define the term 'price.' What are the various modes of fixing the price in a contract of sale? When is price deemed as not capable of being fixed?
8. Write notes on: *(a)* Earnest money, and *(b)* Document of title to goods.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. A dealer in radios gives a 'Murphy' radio to a customer on the terms that Rs 100 should be paid by him immediately and Rs 200 more in two monthly equal instalments. It was further agreed that if the radio is found defective the customer may return it within a week but not later. The customer makes default in paying the last instalment. Can the radio dealer take back the radio on his default?

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[**Hint**. No, the radio dealer cannot take back the radio on default by the customer because it is a contract of sale and not of hire purchase.]

2. *A* agrees to sell to *B* 10 bags of wheat Kalyan (superior) out of 100 bags lying in his godown for Rs 6,500. The wheat is completely destroyed by fire. Can *B* compel *A* to supply the wheat as per agreement?

[**Hint**. Yes, *B* can compel *A*, because the goods forming the subject-matter of the contract in question are *unascertained goods*, the perishing of which does not affect the contract. *A* must supply the wheat from elsewhere or pay damages for the breach.]

3. *P* agrees to sell to *Q* his two motor cars on the terms that the price was to be fixed by *R*. *Q* takes the delivery of one car immediately. *R* refuses to oblige *P* and *Q* and fixes no price. *P* asks for the return of the car already delivered whereas *Q* insists on the delivery of the second car to him for a reasonable price of both the cars. Decide the case.

[**Hint**. The case is governed by Section 10 which provides that if the third party refuses to fix the price, the contract becomes void except as to part of goods delivered and accepted as regards which the buyer must pay a reasonable price. Thus as regards the car already delivered, *P* cannot ask for its return and must accept a reasonable price for that. As regards the second car, *Q* cannot insist on its delivery to him since the contract has become void.]

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Chapter 17

Conditions and Warranties

A contract of sale of goods contains various terms or stipulations regarding the quality of the goods, the price and the mode of its payment, the delivery of goods and its time and place. But all of them are not of equal importance. Some of these stipulations may be *major terms* which go to the very root of the contract and their breach may frustrate the very purpose of the contract, while others may be *minor terms* which are not so vital that their breach may seem to be a breach of the contract as such. In law of sales major terms are called 'conditions' and minor terms are called 'warranties'

From terms of the contract it is necessary to distinguish mere statements of commendation or praise or expressions of opinion made by the seller in reference to his goods. Such commendatory statements are neither 'conditions' nor 'warranties'. They do not form a part of the contract and as a result give no right of action. For example, where a horse dealer, while praising his horse, states that the horse is very lucky and one whosoever shall purchase it must very soon become a millionaire, his statement, being mere commendatory in nature, does not form a part of the contract and its breach (*i.e.,* if the buyer of the horse does not actually become a millionaire later) does not give rise to any legal consequences.

Condition Defined

A 'condition' is a stipulation *essential* to the main purpose of the contract, the breach of which gives the aggrieved party a right to repudiate the contract itself [12(2)]. In addition, he may maintain an action for damages for loss suffered, if any, on the footing that the whole contract is broken and the seller is guilty of nondelivery (*Miller's Machinery Co. Ltd.*vs *David Way & Son*[1]).

Warranty Defined

A 'warranty' is a stipulation *collateral* to the main purpose of the

[1](1934), 40 Com. Cas. 204.

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contract, the breach of which gives the aggrieved party a right to sue for damages only, and not to avoid the contract itself. [Sec. 12(3)]

It will be seen that the above definitions explain both the meaning and the legal effect of a 'condition' and a 'warranty'. Accordingly, a 'condition' forms the very basis of a contract of sale, the breach of which causes irreparable damage to the aggrieved party so as to entitle him even to repudiate the contract, whereas a 'warranty' is only of secondary importance, the breach of which causes only such damage as can be compensated for by damages. In fact a breach of 'condition' is followed by the same consequence as the breach of a 'condition precedent' in other contracts; namely, the innocent party has a right to rescind the contract, and claim damages.

There is no hard and fast rule as to which stipulation is a condition and which one is a warranty. Section 12(4) lays down to the same effect, thus, "whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract. A stipulation may be a condition though called a warranty in the contract." Thus the court is not to be guided by the terminology of the parties but has to look to the intention of the parties by referring to the terms of the contract, its construction and the surrounding circumstances to judge whether a stipulation was a condition or a warranty. The most suitable test to distinguish between the two terms is that if the stipulation is such that its breach would be fatal to the rights of the aggrieved party, then such a stipulation is a condition and where it is not so, the stipulation is only a warranty.

ILLUSTRATIONS. *(a)* A man buys a particular horse which is warranted quiet to ride and drive. If the horse turns out to be vicious, the buyer's only remedy is to claim damages. But if instead of buying a particular horse, a man asks a dealer to supply him with a quiet horse and the dealer supplies him with a vicious one, the stipulation is a condition, and the buyer can return the horse and can also claim damages for breach of contract (*Hartley* vs *Hyman*[2]).

(b) *P* goes to *R*, a horse dealer, and says, "I want a horse which can run at a speed of 30 kilometers per hour." The horse dealer points out a particular horse and says, "This will suit you." *P* buys the horse. Later on *P* finds that the horse can run only at a speed of 20 kilometers per hour. There is a breach of condition, *P* can repudiate the contract, return the horse to *R* and get back the price.

But if *P* says to *R*, "I want a good horse." *R* shows him a horse and says, "This is a good horse and it can run at a speed of 30 kilometers per hour," and *P* buys the horse and finds later on that it can run at a speed of 20 kilometers per hour only, there is a breach of warranty because the stipulation made by the seller did not form the very basis of the contract and was only subsidiary one. The seller gave the assurance about the running speed of the horse of his own without being asked by the buyer hence it is only of secondary importance.

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The above illustrations are a clear proof of the fact that an exactly similar term may be a condition in one contract and a warranty in another depending upon the construction of the contract as a whole.

Condition and Warranty Distinguished

The points of distinction between a condition and a warranty may be summed up as under:

1. **As to value.** A condition is a stipulation which is essential to the main purpose of the contract, whereas a warranty is a stipulation which is collateral to the main purpose of the contract. [Sec. 12(2)(3)]

2. As to breach. The breach of a condition gives the aggrieved party the right to repudiate the contract and also to claim damages, whereas the breach of warranty gives the aggrieved party a right to claim damages only.

3. As to treatment. A breach of condition may be treated as a breach of warranty. But a breach of warranty cannot be treated as a breach of condition.

When Breach of Condition is to be Treated as Breach of Warranty

Section 13 deals with cases where a breach of condition is to be treated as a breach of warranty, as a consequence of which the buyer loses his right to rescind the contract and has to be content with a claim for damages only. These cases are as follows:

1. **Voluntary waiver by buyer.** Although on a breach of condition by the seller, the buyer has a right to treat the contract as repudiated and reject the goods, but he is not bound to do so. He may instead elect to waive the condition, *i.e.*,to treat the breach of condition as a breach of warranty and accept the goods and sue the seller for damages for breach of warranty.

ILLUSTRATION. *A* agrees to supply *B* 10 bags of first quality sugar @ Rs. 625 per bag but supplies only second quality sugar, the price of which is Rs. 600 per bag. There is a breach of condition and the buyer can reject the goods. But if the buyer so elects, he may treat it as a breach of warranty, accept the second quality sugar and claim damages @ Rs. 25 per bag.

2. **Acceptance of goods by buyer.** Where the buyer has *accepted* the goods and subsequently he comes to know of the breach of condition, he cannot reject them, but can only maintain an action for damages. This case does not depend upon the will of the buyer but the law compulsorily treats a breach of condition as a breach of warranty.

Acceptance of only part of the goods. If the buyer has accepted only part of the goods and the contract is *indivisible,* he will have to treat the breach of condition as a breach of warranty and accept the remaining part also. But in case of *divisible* contracts, he can repudiate as regards remaining goods, if he has accepted only part thereof. Indivisible contracts are those where price for a lot, consisting goods of different qualities, as such

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is fixed and not fixed per unit or per bag or per ton, *etc.*

Meaning of 'acceptance'. Taking possession or delivery of the goods does not by itself amount to acceptance. According to Section 42, the buyer is deemed to have accepted the goods:

(i) when he intimates to the seller that he has accepted them; or

(ii) when he does any act in relation to goods which is inconsistent with the ownership of the seller, *e.g.,* consumes, uses, pledges or resells the goods or puts his mark on them, *etc.*; or

(iii) when, after the lapse of reasonable time, he retains the goods without intimating the seller that he has rejected them. On rejection of goods, however, mere informing the seller is enough and the buyer is not bound to return the rejected goods actually (Sec. 43).

Express and Implied Conditions and Warranties

Conditions and warranties may be either express or implied. They are said to be express when at the will of the parties they are inserted in the contract, and they are said to be implied when the law presumes their existence in the contract automatically though they have not been put into it in express words. Implied conditions and warranties may, however, be negatived or varied by express agreement, or by course of dealing between the parties, or by usage of trade (Sec. 62). This provision is merely an application of the general maxim of law, 'what is expressly done puts an end to what is tacit or implied,' and 'custom and agreement over-rule implied conditions and warranties.'

Implied Conditions

Unless otherwise agreed, the law incorporates into a contract of sale of goods the following implied conditions:

1. **Condition as to title** [Sec. 14 *(a)*]. In every contract of sale, the first implied condition on the part of the seller is that, in the case of a sale, he has the right to sell the goods and that, in the case of an agreement to sell, he will have a right to sell the goods at the time when the property is to pass. Ordinarily the seller has the right to sell the goods if either he is the owner of the goods or he is owner's agent. As a result of this condition, if the seller's title turns out to be defective the buyer is entitled to reject the goods and to recover his price. Notice that in the case of breach of condition as to title the buyer has no option to treat the breach of condition as breach of warranty and accept the goods and sue the seller for damages. In this case he must return the goods to the true owner. He can of course recover the price from the seller because of a total failure of consideration.

ILLUSTRATION. *R* purchased a motorcar from *D* and used the same for several months. *D* had no title to the car and, therefore, *R* was compelled to return the car to the true owner. *R* sued *D* to recover back the price which he had already

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paid. He was held entitled to recover the whole of the price paid by him despite the fact that he had used the car for some months *(Rowland* vs *Divall*[3]).

It may be noted that the implied condition as to title makes it obligatory upon the seller that he must not only be the owner but also must be able to uphold the validity of the contract. Thus if the goods sold bear labels infringing the trade mark of another, the seller is guilty of breach of this condition although he had full ownership of the goods.

ILLUSTRATION. In *Niblett* vs *Confectioner's Materials Co.*[4]; the defendants sold to the plaintiff 3,000 tins of condensed milk C.I.F. from New York to London. On their arrival in London it was found that 1,000 tins were labelled "Nissly Brand." Nestle Co., another manufacturer of condensed milk, proved that this was an infringement of its trade mark. The plaintiff had to remove all the labels. The tins were in consequence sold at a loss. The plaintiff sued the defendants for the breach of the condition as to title and claimed compensation for the same. It was held that as the defendants had no right to sell the goods, there being infringement of another company's trade mark, they were bound to pay damages for the loss suffered by the plaintiff.

It may further be noted that where a seller having no title to the goods at the time of the sale, subsequently acquires the title (*e.g.*, by paying off the true owner) *before the buyer seeks to repudiate the contract,* that title feeds the defective titles of both the original and subsequent buyers and it will then be too late for the buyer to repudiate the contract (*Patten* vs *Thomas Motors*[5]).

2. Condition in a sale by description. "Where there is a contract of sale of goods by description, there is an implied condition that the goods shall correspond with the description ..." (Sec. 15). Lord Blackburn observed:[6] "If you contract to sell peas, you cannot oblige a party to take beans. If the description of the article tendered is different in any respect, it is not the article bargained for, and the other party is not bound to take it." It is important that the goods must correspond with the description whether it is a sale of specific goods or of unascertained goods. Further, the fact that the buyer has examined the goods will not affect his right to reject the goods, if the deviation of the goods from the description is such which could not have been discovered by casual examination, *i.e.*, if the goods show any latent defects.

The description may be in terms of the qualities or characteristics of the goods, *e.g.*, long staple cotton, Kalyan wheat, sugar C-30, basmati rice or may simply mention the trade mark, brand name or the type of packing, *etc.*

[3](1923), 2 K.B. 500.
[4](1921), 3 K.B. 387.
[5](1965), N.S.W.R. 1457.
[6]In *Bowes* vs *Shand,* (1877), 2 A.C. 455.

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ILLUSTRATIONS. *(a)* Where there was a contract for the supply of 'new singer cars' and one of the cars supplied having already run a considerable mileage was not new, there was a breach of condition on the part of the seller and the buyer was held entitled to reject the car (*Andrews Bros.* vs *Singer & Co.*[7]).

(b) M agreed to supply to *L* 3,000 tins of canned fruit, to be packed in cases each containing 30 tins. *M* tendered a substantial portion in cases containing 24 tins. It was held that the mode of packing constituted a part of the description and, therefore, *L* was entitled to reject the whole consignment (*Re Moore & Co., and Landaure & Co.*[8]).

3. **Condition in a sale by sample** (Sec. 17). When under a contract of sale, goods are to be supplied according to a sample agreed upon, the implied conditions are:

(i) that the bulk shall correspond with the sample in quality;

(ii) that the buyer shall have a reasonable opportunity of comparing the bulk with the sample;

(iii) that the goods shall be free from any defect, rendering them unmerchantable, which would not be apparent on reasonable examination of the sample. In other words, there should not be any latent defect in the goods. If the defect is patent one, that is, easily discoverable by the exercise of ordinary care, and the buyer takes delivery after inspection, there is no breach of implied condition and the buyer has no remedy.

ILLUSTRATIONS. *(a)* Two parcels of wheat were sold by sample. The buyer went to examine the bulk a week after. One parcel was shown to him but the seller refused to show the other parcel which was not there in the warehouse. *Held,* the buyer was entitled to rescind the contract (*Lorymer* vs *Smith*[9]).

(b) Some mixed worsted coatings were sold by sample. The goods when supplied corresponded to the sample but it was found that owing to a latent defect in the cloth, coats made out of it would not stand ordinary wear and were therefore unsaleable. The same defect existed in the sample also but could not be detected on a reasonable examination. *Held,* the buyer was entitled to reject the cloth (*Drummond & Sons* vs *Van Ingen*[10]).

4. **Condition in a sale by sample as well as by description** (Sec. 15). When goods are sold by sample as well as by description, there is an implied condition that the bulk of the goods shall correspond both with the sample and with the description. If the goods supplied correspond only with the sample and not with the description or *vice versa,* the buyer is entitled to reject the goods. The bulk of the goods must correspond with both.

ILLUSTRATIONS. *(a)* There was a contract of sale by sample of seeds described as 'common English sainfoin.' The contract contained a term excluding all warranties express or implied. The seed was sown and when the crop was ready

[7](1934), 1 K.B. 17.
[8](1921), 2 K.B. 519.
[9](1822), 1 B. & C. 1.
[10](1887), 12 A.C. 284.

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it was discovered that the seed supplied and the sample shown were a different and inferior variety known as 'giant sainfoin' It was held that there was a breach of condition and the exemption clause did not protect the sellers. The buyer was, therefore, entitled to recover damages (*Wallis* vs *Pratt*[11]).

(b) N agreed to sell *G* some oil described as 'foreign refined rape oil,' warranted only equal to sample. The oil supplied, though corresponded with the sample, was adulterated with hemp oil. *Held,* that since the oil supplied was not in accordance with the description the buyer was entitled to reject the same (*Nichol* vs *Godts*[12]).

5. **Condition as to fitness or quality** [Sec. 16 (1)]. Ordinarily, in a contract of sale there is no implied condition or warranty as to quality or fitness for any particular purpose of goods supplied; the rule of law being '*Caveat Emptor*',[13] that is, let the buyer beware. But an implied condition is deemed to exist on the part of the seller that the goods supplied shall be reasonably fit for the purpose for which the buyer wants them, if the following conditions are satisfied:

(i) The buyer, expressly or impliedly, should make known to the seller the particular purpose for which the goods are required; and

(ii) The buyer should rely on the seller's skill or judgment; and

(iii) The goods sold must be of a description which the seller deals in the ordinary course of his business, whether he be the manufacturer or not.

The purpose must be made known expressly if the goods to be supplied can be used for several purposes, otherwise the condition as to fitness will not be implied and the buyer will have no right to reject the goods merely because they are unfit for the specific purpose he had in mind.

ILLUSTRATION. A buyer ordered for the hessian cloth, which is generally used for packing purposes, without specifying the purpose for which he wanted the same. The cloth was supplied accordingly. On receiving the cloth the buyer found that it was not suitable for packing food products as it had an unusual smell. *Held,* that the buyer had no right to reject the cloth as it was suitable for packing purposes alright. The buyer ought to have disclosed his particular purpose to the seller in order to make him liable for the breach of implied condition as to fitness (*Re Andrew Yule & Co.*[14]).

The purpose need not be told expressly if the goods are fit for one particular purpose only or if the nature of the goods itself tells the purpose by implication. In such cases the purpose is deemed to be made known to the seller impliedly.

ILLUSTRATIONS. *(a) A*, a draper, who had no special knowledge of hot

[11](1911), A.C. 394.

[12](1854), 10 Ex. 191.

[13]The doctrine of *Caveat Emptor* has been discussed separately later in this Chapter.

[14]A.I.R. (1932), Cal. 879.

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water bottles, went to the shop of a chemist and asked for a hot water bottle. He was shown an American rubber bottle which the chemist said would not stand boiling water, but was meant for hot water. *A* bought the bottle. After a few days, while being used, it burst and injured his wife. It was found that the bottle was not fit for use as a hot water bottle. It was held that since the bottle could be used only for one particular purpose, there was a breach of implied condition as to fitness and the seller was liable to pay damages (*Priest* vs *Last*[15]).

(b) Where a buyer demands tinned fruit juice, it is implied from the nature of the product itself that he wants it for consumption and if later on it is found to contain poisonous matter, there is a breach of implied condition as to fitness and the seller is liable in damages.

Sometimes the implied purpose may also be gathered from usage of the trade, *e.g.*, mobiloil for a scooter implies "two T's mobiloil."

It is important that the implied condition as to fitness applies only in the case of sale of goods to a normal buyer. If the buyer is suffering from an abnormality; say, is allergic to particular foods, medicines, dust, etc., and it is not made known to the seller at the time of sale, this condition does not apply.

Sale under patent or trade name. Proviso to Section 16(1) lays down that in the case of a contract for the sale of a specified article under its patent or other trade name, there is no implied condition as to its fitness for any particular purpose. It is so because in such a case the buyer is not relying on the skill and judgement of the seller but relies on the good reputation that the goods came to acquire and buys them on the strength of that reputation. The seller's duty is to supply the goods of the same trade name as demanded by the buyer, whether they are fit for any particular purpose or not, is not his concern.

ILLUSTRATION. The buyer wrote to the seller: "Send me your patent smoke-consuming furnace for fitting up in my brewery." The seller supplied the furnace according to the order but the same was found to be not fit for the purpose of the buyer's brewery. It was held that the seller had performed his part of the contract by supplying his patented furnace and so he was entitled to recover its price from the buyer (*Chanter* vs *Hopkins*[16]).

But the condition as to fitness will apply if the buyer relies on the seller's skill and judgment as regards the suitability of the goods for a particular named purpose and makes known to the seller that he so relies on him, even though the article is described in the order by its trade name.

ILLUSTRATION. *B* approached *M*, a motorcar dealer, and asked for a comfortable car suitable for touring purposes. *M* recommended his 'Bugatti' car, a trade name and also showed a specimen of the same. *B* thereupon ordered for a 'Bugatti' car, which was supplied. The car proved to be unsuitable for touring

[15](1903), 2 K.B. 148.

[16](1838), 4 M. & W. 399.

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purposes. *B* claimed to reject the car and recover back the purchase money paid by him. It was held that he was entitled to do so because while ordering the car by its trade name he was still relying on the seller's skill and judgement as regards the suitability of the car for the specific purpose (*Baldry* vs *Marshall*[17]).

6. **Condition as to merchantability** [Sec. 16(2)]. This condition is implied only where the sale is by description. We have already seen that there is an implied condition in such cases, as per Section 15, that the goods should correspond with the description. This subsection lays down another implied condition in such cases, that is, that the goods should be of 'merchantable quality.' But for making this condition applicable, not only that the sale must be by description, but the following conditions must also be satisfied:

(i) The seller should be a dealer in goods of that description, whether he be the manufacturer or not; and

(ii) The buyer must not have any opportunity of examining the goods or there must be some latent defect in the goods which would not be apparent on reasonable examination of the same.

If the buyer had an opportunity of making the examination but he avoids to examine, or if he has examined the goods, there is no implied condition as to merchantability as regards defects which such examination ought to have revealed [Proviso to Sec. 16(2)].

The phrase 'merchantable quality' means that the goods are of such quality and in such condition that a reasonable man, acting reasonably, would accept them under the circumstances of the case in performance of his offer to buy those goods, whether he buys them for his own use or to sell again (*S.S.Mendse* vs *Balkrishna Chettiar*[18]). Stated briefly, in order to be 'merchantable' the goods must be such as are reasonably saleable under the description by which they are known in the market.

ILLUSTRATIONS. *(a)* Where the underwears supplied contained certain chemicals which could cause skin disease to a person wearing them next to skin, it was held that because of such a defect the underwears were not of merchantable quality and the buyer was entitled to reject the goods (*Grant* vs *Australian Knitting Mills Ltd.*[19]).

(b) Where *A* purchases a certain quantity of black yarn from *B*, a dealer in yarn, and finds it damaged by white ants, the condition as to merchantability has been broken and *A* is entitled to reject it as unmerchantable.

(c) *R* ordered for some 600 motor horns of varying description. Some of the horns were dented and badly polished and *R* rejected the whole of the consignment. *Held*, the defects in the horns had rendered them unmerchantable and therefore the

[17](1925), 1 K.B. 260.
[18](1963), 2 M.L.J. 140.
[19](1936), A.C. 85.

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buyer was justified in rejecting the *whole* consignment as the contract is indivisible (*Jackson* vs *Rotax Motor and Cycle Co.*[20]).

(d) A wanted to purchase some glue. The glue was stored in the seller's warehouse in barrels. Every facility was given to *A* for its inspection but he did not have the barrels opened and simply looked at the outside of the barrels. The glue was found to have defects which would have been found out if *A* had inspected the contents of the barrels. It was held that there was no breach of any implied condition as to merchantability and as such *A* was not entitled to any relief (*Thornett* vs *Beers*[21]).

7. Condition as to wholesomeness. This condition is implied only in a contract of sale of eatables and provisions. In such cases the goods supplied must not only answer to description and be merchantable but must also be wholesome, *i.e.*, free from any defect which render them unfit for human consumption.

ILLUSTRATIONS. *(a) F* bought milk from *A*, a dairy owner. The milk was contaminated with germs of typhoid fever. *F*'s wife, on taking the milk, became infected and died of it. *A*, was held liable in damages (*Frost* vs *Aylesbury Dairy Co. Ltd.*[22]).

(b) The plaintiff bought a bun at a baker's and confectioner's shop. The bun contained a stone which broke one of the plaintiff's teeth. *Held,* the seller was liable in damages because he violated the condition of wholesomeness (*Chaproniere* vs *Mason*[23]).

(c) W bought a bottle of beer from *H*, a dealer in wines. The beer was contaminated with arsenic. *W*, on taking the beer, fell ill. *H* was held liable to *W* for the consequent illness (*Wren* vs *Halt*[24]).

Implied Warranties

Unless otherwise agreed, the law also incorporates into a contract of sale of goods the following implied warranties:

1. **Warranty of quiet possession** [Sec. 14*(b)*]. In every contract of sale, the first implied warranty on the part of the seller is that "the buyer shall have and enjoy quiet possession of the goods." If the quiet possession of the buyer is in any way disturbed by a person having a superior right than that of the seller, the buyer can claim damages from the seller. Since disturbance of quiet possession is likely to arise only where the seller's title to goods is defective, this warranty may be regarded as an extension of the implied condition of title provided for by Section 14(*a*). In fact the two clauses of Section 14 [*i.e., (a)* and *(b)*] are overlapping and it is not easy

[20](1910), 2 K.B. 937.
[21](1919), 1 K.B. 486.
[22](1905), 1 K.B. 608.
[23](1905), 21 T.L.R. 633.
[24](1903), 1 K.B. 610.

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to see what additional rights this warranty confers on the buyer over and above those conferred by the implied condition as to title contained in Section 14*(a)*.

ILLUSTRATION. The plaintiff, a lady, purchased a second hand typewriter from the defendant. She thereafter spent some money on its repair and used it for some months. Unknown to the parties the typewriter was a stolen one and the plaintiff was compelled to return the same to its true owner. She was held entitled to recover from the sellers for the breach of this warranty damages reflecting not merely the price paid but also the cost of repair (*Mason* vs *Burningham*[25]). [Notice that the decision in the instant case would not change if we treat it as a case of breach of condition as to title under Sec. 14*(a)*].

2. **Warranty of freedom from encumbrances** [Sec. 14*(c)*]. The second implied warranty on the part of the seller is that "the goods shall be free from any charge or encumbrance in favour of any third party not declared or known to the buyer before or at the time when the contract is made." If the goods are afterwards found to be subject to a charge and the buyer has to discharge the same, there is breach of warranty and the buyer is entitled to damages. It is to be emphasised that the breach of this warranty occurs only when the buyer in fact discharges the amount of the encumbrance, and he had no notice of that at the time of the contract of sale. If the buyer knows about the encumbrance on the goods at the time of entering into the contract, he becomes bound by the same and he is not entitled to claim compensation from the seller for discharging the same.

ILLUSTRATION. *A*, the owner of the watch, pledges it with *B*. After a week, *A* obtains possession of the watch from *B* for some limited purpose and sells it to *C*. *B* approaches *C* and tells him about the pledge affair. *C* has to make payment of the pledge amount to *B*. There is breach of this warranty and *C* is entitled to claim compensation from *A*. [Notice that in the instant case the buyer (*i.e.*, *C*) cannot allege breach of implied condition as to title against the seller (*i.e.*, *A*) because the seller in fact had a title to the goods, though subject to the rights of the pledgee].

3. **Warranty of disclosing the dangerous nature of goods to the ignorant buyer.** The third implied warranty on the part of the seller is that in case the goods sold are of dangerous nature he will warn the ignorant buyer of the probable danger. If there is breach of this warranty the buyer is entitled to claim compensation for the injury caused to him. Romer L.J. observed,[26] "I think that, apart from any question of warranty, there is a duty cast upon a vendor, who knows of the dangerous character of goods which he is supplying, and also knows that the purchaser is not, or may not

[25](1949), 2 K.B. 545.
[26]In *Clarke* vs *Army & Navy Cooperative Society Ltd.*, (1903), 1 K.B. 155, at p. 166.

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be, aware of it, not to supply the goods without giving some warning to the purchaser of that danger."

ILLUSTRATION. *C* purchases a tin of disinfectant powder from *A*. *A* knows that the lid of the tin is defective and if it is opened without special care it may be dangerous, but tells nothing to *C*. *C* opens the tin in the normal way whereupon the disinfectant powder flies into her eyes and causes injury. *A* is liable in damages to *C* as he should have warned *C* of the probable danger.[27]

Doctrine of Caveat Emptor

The maxim of *caveat emptor* means "let the buyer beware." According to the doctrine of *caveat emptor* it is the duty of the buyer to be careful while purchasing goods of his requirement and, in the absence of any enquiry from the buyer, the seller is not bound to disclose every defect in goods of which he may be cognisant. The buyer must examine the goods thoroughly and must see that the goods he buys are suitable for the purpose for which he wants them. If the goods turn out to be defective or do not suit his purpose, the buyer cannot hold the seller liable for the same, as there is no implied undertaking by the seller that he shall supply such goods as suit the buyer's purpose. If, therefore, while making purchases of goods the buyer depends upon his own skill and makes a bad choice, he must curse himself for his own folly, in the absence of any misrepresentation or fraud or guarantee by the seller.

ILLUSTRATIONS. *(a) A* purchases a horse from *B*. *A* needed the horse for riding but he did not mention this fact to *B*. The horse is not suitable for riding but is suitable only for being driven in the carriage. *Caveat emptor* being the rule, *A* can neither reject the horse not can he claim any compensation from *B*.

(b) Certain pigs were sold by auction "with all faults." The pigs were suffering from typhoid fever and all of them but one died. They also infected a few of the buyer's own pigs. It was held that the seller was not bound to disclose that the pigs were unhealthy. *Caveat emptor* being the rule, the buyer could not claim damages from the seller (*Ward* vs *Hobbs*[28]).

Exceptions. The doctrine of *caveat emptor* is subject to the following exceptions:

1. Where the seller makes a *mis-representation* and the buyer relies on it, the doctrine of *caveat emptor* does not apply. Such a contract being voidable at the option of the innocent party, the buyer has a right to rescind the contract.

2. Where the seller makes a false representation amounting to *fraud* and the buyer relies on it, or where the seller actively conceals a defect in the goods so that the same could not be discovered on a reasonable exami-

[27] *Ibid.*
[28] (1878), 4 A.C. 13.

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nation, the doctrine of *caveat emptor* does not apply. Such a contract is also voidable at the option of the buyer and the buyer is entitled to avoid the contract and also claim damages for fraud.

3. Where the goods are purchased by description and they do not correspond with the description (Sec. 15). (*See* implied condition 'in a sale by description' discussed earlier).

4. Where the goods are purchased by description from a seller who deals in such class of goods and they are not of 'merchantable quality', the doctrine of *caveat emptor* does not apply. But the doctrine applies, if the buyer has examined the goods, as regards defects which such examination ought to have revealed [Sec. 16(2)]. (*See* implied condition 'as to merchantability' discussed earlier).

5. Where the goods are bought by sample, the doctrine of *caveat emptor* does not apply if the bulk does not correspond with the sample, or if the buyer is not provided an opportunity to compare the bulk with the sample, or if there is any hidden or latent defect in the goods (Sec. 17). (*See* implied condition 'in a sale by sample' discussed earlier).

6. Where the goods are bought by sample as well as by description and the bulk of the goods does not correspond both with the sample and with the description, the buyer is entitled to reject the goods (Sec. 15). (See implied condition 'in a sale by sample as well as by description' discussed earlier).

7. Where the buyer makes known to the seller the purpose for which he requires the goods and relies upon the seller's skill and judgment but the goods supplied are unfit for the specified purpose, the principle of *caveat emptor* does not protect the seller and he is liable in damages [Sec. 16(1)]. (*See* 'condition as to fitness or quality' discussed earlier).

8. Where the trade usage attaches an implied condition or warranty as to quality or fitness and the seller deviates from that, the doctrine of *caveat emptor* does not apply and the seller is liable in damages [Sec. 16(3)].

TEST QUESTIONS

1. Define and distinguish between a condition and a warranty. Under what circumstances a breach of condition is to be treated as a breach of warranty?

2. Explain briefly the implied conditions and warranties in a contract of sale of goods.

3. *(a)* What are the differences between 'conditions' and 'warranties'?

(b) *P* bought a car from *Q* who had no title to it. *P* used the car for several months. After that the true owner came forward and demanded the car. State the rights of *P* and the true owner of the car.

4. State the doctrine of *caveat emptor* and explain the exceptions to it.

5. "In a contract for the sale of goods, there is no implied condition or warranty as to the quality of the goods or their fitness for any particular purpose." Comment.

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PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. Worsted coating of quality equal to sample was sold to tailors who could not stitch it into coats owing to some latent defect in its texture. The tailors had examined the cloth before effecting the purchase. Are they entitled to damages?

[**Hint**. In a contract of sale by sample there is an implied condition that the goods shall be free from any latent or hidden defect (Sec. 17). As this implied condition is broken in the instant case, the tailors are entitled to recover damages.]

2. Soda-water was supplied by *S* to *B* in bottles. *B* was injured by the bursting of one of the bottles. Can *B* claim damages from *S*?

[**Hint**. *B* can claim damages from *S* for the injury as the bottle is not of merchantable quality and there is a sale of goods by description. (Refer to Condition as to Merchantability.)]

3. *M* was shopping in a self-service super market. He picked up a bottle of orange squash from a shelf. While he was examining it, the bottle exploded in his hand and injured him. Can *M* claim damages for the injury?

[**Hint**. *M* cannot claim damages because a warranty or condition as to merchantability does not arise unless there is a sale. As there was no sale (since *M* may decide not to buy and put back the bottle in the shelf), there was no implied condition.]

4. *A* agrees to supply to *B* a certain quantity of timber of half-inch thickness. The timber actually supplied varies in thickness from one-third inch to five-eighth inch. The timber is merchantable and commercially fit for the purpose for which it was ordered. *B* rejects the timber. Is his action justified?

[**Hint**. Yes, *B* is entitled to reject the goods. The facts of the given case are similar to *Arcos Ltd.* vs *E.A. Ronaasen & Son,* 1933, A.C. 470, in which case Lord Atkin observed: "If the contract specifies conditions of weight, measurement and the like, those conditions must be complied with. A ton does not mean about a ton, or a yard about a yard. Still less, when you descend to minute measurements, does half an inch mean about half inch. If the seller wants a margin he must, and in my experience does, stipulate for it."]

5. A lady, who knew that her skin was abnormally sensitive, bought a tweed coat and developed skin trouble by using it. She did not disclose to the seller that her skin was abnormally sensitive. Is the seller liable for breach of implied condition as to fitness or quality?

[**Hint**. The implied condition as to fitness or quality is with regard to the suitability of the goods to a normal buyer. If the buyer is suffering from an abnormality and does not inform the seller about the same, this implied condition does not apply. Hence in the given case there is no breach of implied condition as to fitness and as such the seller is not liable. (*Griffiths* vs *Peter Conway Ltd.*, 1939, 1 All. E.R. 685).]

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Chapter 18

Transfer of Property

While defining a contract of sale in Chapter 16 we have seen that a sale is primarily the transfer of property in goods by the seller to the buyer. The phrase "transfer of property in goods" means transfer of ownership of the goods. 'Property in goods' is different from possession of goods. Possession refers to the custody over the goods. So the property in goods may pass from the seller to the buyer but the goods may be in possession of the seller either as unpaid seller or as a bailee for the buyer. In other cases the property in goods may still be with the seller although the goods may be in possession of the buyer or his agent or a carrier for transmission to the buyer.

The precise moment of time at which property in goods passes from the seller to the buyer is of great importance from various points of view. Of these the following require special notice:

1. **Risk 'prima-facie' passes with property**. As a general rule the risk of the loss of goods is *prima-facie* in the person in whom property is. Section 26 provides to the same effect, thus, "Unless otherwise agreed, the goods remain at the seller's risk until the property therein is transferred to the buyer, but when the property therein is transferred to buyer, the goods are at the buyer's risk whether delivery has been made or not." Thus, if after the contract the goods are destroyed or damaged the question who is to bear the loss is to be decided not on the basis of possession of the goods but on the basis of ownership of goods. Whosoever is the owner of the goods at the time of loss must bear the loss.

ILLUSTRATION. *A* buys goods from *B* and property has passed to him, but the goods remain in *B*'s warehouse. Before delivery of goods to *A*, there is a fire in *B*'s warehouse and all the goods are destroyed. *A* must bear the loss and pay the price of goods to *B*, if he has not paid it so far.

The opening words of Section 26, namely, 'unless otherwise agreed' are of great significance. These words imply that 'risk passes with property' is not an absolute or inflexible rule, but a *prima facie* one. *Risk is no test of property passing.* There is nothing to prevent the parties from contracting that risk shall pass even before passing of property or *vice versa.*

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The proviso to Section 26 also lays down an exception to the rule that 'risk follows ownership.' It provides that where delivery of the goods has been delayed through the fault of either buyer or seller, the goods are at the risk of the party in fault as regards any loss which might not have occurred but for such fault.

ILLUSTRATION. *A* contracted to purchase 30 tons of apple juice from *B*. *B* crushed the apples and filled 30 tons of juice in casks and kept them ready for delivery. After a few casks had been delivered, *A* refused to take further deliveries. The juice became putrid and had to be thrown away. *Held,* although the property in good was still with *B*, yet the loss had to be borne by *A (Demby Hamilton & Co. Ltd.* vs *Barden*[1]).

2. **Action against third parties.** If after the contract of sale, the goods have been damaged by a third party, it is only the person in whom the property vests who can take action against the wrongdoer.

3. **Suit for price.** Generally speaking the seller can only sue for the price if the property in goods has passed to the buyer.[2]

4. **Insolvency of the seller or the buyer.** In the event of insolvency of either the seller or the buyer, the answer to the question whether the Official Receiver or Assignee can take over the goods or not, shall depend upon whether the property in goods was with the party who has become insolvent. For example, if the seller becomes insolvent before giving delivery of the goods but the property in goods has already passed to the buyer, the Official Receiver can have no claim against the goods.

Rules Regarding Transfer of Property

We shall be studying the rules regarding transfer of property under the following two heads:

1. Transfer of property in specific or ascertained goods.
2. Transfer of property in unascertained and future goods.

Transfer of Property in Specific or Ascertained Goods

Where there is a contract for the sale of specific or ascertained goods the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred. For the purpose of ascertaining the intention of the parties regard shall be had to the terms of the contract, the conduct of the parties and the circumstances of the case [Sec. 19(1) (2)]. Thus, in the case of specific goods, the transfer of property takes place

[1](1949), 1 All E.R. 435.

[2]As an exception to this general rule, Section 55(2) provides that where price is payable 'on a day certain' and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price although the property in the goods has not passed and the goods have not been appropriated to the contract.

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when the parties intend to pass it. The parties may intend to pass the property at once at the time of making of the contract or when the goods are delivered or when the goods are paid for.

It is only when the intention of the parties cannot be judged from their contract or conduct or other circumstances that the rules laid down in Sections 20, 21, 22 and 24 apply [Sec. 19(3)]. These rules are as follows:

1. **When goods are in a deliverable state** (Sec. 20). Where there is an unconditional (*i.e.*, not subject to any condition precedent to be fulfilled by the parties) contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer as soon as the contract is made, and it is immaterial whether the time of payment of the price or the time of delivery of the goods, or both are postponed.

ILLUSTRATIONS. *(a) A* buys a bicycle for Rs 300 on a month's credit and asks the shopkeeper to send it to his house. The shopkeeper agrees to do so. The bicycle immediately becomes the property of *A*.

(b) P buys a table for Rs 100 on a week's credit and arranges to take delivery of the table the next day. A fire broke out in the furniture mart the same evening and the table is destroyed. The property in the table has passed to *P* and he is bound to pay the price.

The goods are said to be in a 'deliverable state' when they are in such a state that the buyer would, under the contract, be bound to take delivery of them [Sec. 2(3)]. For example, in illustration *(b)* above, if the seller has to polish the table to make it acceptable to the buyer, it is not in a deliverable state until it is so polished, and the buyer does not acquire property at the time of the contract.

2. **When goods have to be put into a deliverable state** (Sec. 21). Where there is a contract for the sale of specific goods and the seller is bound to do 'something' to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done and the buyer has notice thereof. The word 'something' here means an act like packing the goods, or loading them on rail or ship, or filling them in containers or polishing them in order to give a finished shape, etc. It is to be noted that merely putting the things in a deliverable state would not result in the transfer of property in the goods from the seller to the buyer. It is further necessary that the buyer must have notice thereof, *i.e.*, the fact that the goods have been put in a deliverable state must come to the knowledge of the buyer in some way or the other.

ILLUSTRATION. *A* agrees to sell to *B* the whole of turpentine oil lying in a cistern. It is further agreed that the oil is to be put into casks by *A* and then *B* is to take them away. Some of the casks are filled *in the presence of B*, but before any are removed or the remainder filled, the whole is destroyed accidentally by fire. *B* must bear the loss of oil which had been put into the casks because in all these casks the property has passed to him as nothing further remained to be done

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to them by the seller. But the property in the casks not filled up remained in the seller, at whose risk they continued (*Rugg* vs *Minett*[3]).

3. **When the goods have to be measured etc., to ascertain price** (Sec. 22). Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done and the buyer has notice thereof.

ILLUSTRATION. *A* sold to *B* 289 bales of goat skins, each bale containing five dozens, and the price was for certain sum per dozen skins. It was the duty of *A* to count the goat skins in each bale. Before *A* could do the same, the bales were destroyed by fire. *Held,* that the property in the goods had not passed to the buyer (*i.e.*, *B*) as something still remained to be done by the seller (*i.e.*,*A*) for ascertaining the price, and as such the loss caused by fire had to be borne by the seller (*i.e.*,*A*) (*Zagury* vs *Furnell*[4]).

It may be noted that if the seller has done all what he was required to do under the contract and nothing remains to be done by him, the property passes to the buyer even if the buyer has to do something for his own satisfaction.

ILLUSTRATION. *A* contracted with *B* to sell him 975 maunds of rice, the whole content of a certain 'golah'. *B* paid the entire price but agreed to remove the rice after weighing (for his own satisfaction) before a certain date. After delivery was taken of a part of the rice the other part was destroyed by fire. *Held,* the ownership had passed to the buyer because nothing remained to be done by the seller to ascertain the price, and therefore *B*, the buyer, must suffer the loss (*Shoshi Mohun Pal* vs *Nobo Kristo Poddar*[5]).

4. **When goods are delivered on approval** (Sec. 24). When goods are delivered to the buyer on approval or 'on sale or return,' or on other similar terms, the property therein passes to the buyer:

(i) When he signifies his approval or acceptance to the seller or does any other act adopting the transaction, *e.g.*, pledges the goods or resells them;

(ii) If he does not signify his approval or acceptance to the seller but retains the goods, without giving notice of rejection, beyond the time fixed for the return of goods, or if no time has been fixed, beyond a reasonable time.

ILLUSTRATIONS. *(a) A* delivered a horse to *B* on the terms of 'sale or return, within 8 days.' The horse died on the third day without any fault on the part of *B. Held, A* was to bear the loss as the horse was still his property when it perished (*Elphick* vs *Barnes*[6]).

[3](1809), 11 East 210.
[4](1809), 2 Camp. 240.
[5](1878), 4 I.L.R. Cal. 801.
[6](1880), 5 C.P.D. 321.

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(b) *A* delivered a horse to *B* on trial for 8 days. *B* continued to retain the horse even after the expiry of 8 days without giving notice of rejection to *A*. *B* had automatically become the owner of the horse on the expiry of 8 days.

Transfer of Property in Unascertained and Future Goods

The rule relating to transfer of property in unascertained and future goods[7] is contained in Sections 18 and 23. These Sections provide that where goods contracted to be sold are not ascertained or where they are future goods, the property in goods does not pass to the buyer unless and until the goods are ascertained or unconditionally appropriated to the contract so as to bring them in a deliverable state, either by the seller with the assent of the buyer or by the buyer with the assent of the seller. Such assent may be expressed or implied, and may be given either before or after the appropriation is made.

It must be noted that the above rule (as contained in Secs. 18 and 23) is a fundamental rule and it applies irrespective of what the parties intended. Until goods are ascertained or appropriated there is merely 'an agreement to sell.' Thus a sale of ten quintals of wheat from a granary containing a large quantity, has not the effect of transferring property in the ten quintals to the purchaser. It amounts only to 'an agreement to sell.' It is only when ten quintals are appropriated to the contract by the seller and the buyer has notice thereof, that property shall pass from the seller to the buyer.

The process of ascertainment or appropriation consists in earmarking or setting apart goods as subject-matter of the contract. It involves separating, weighing, measuring, counting or similar acts done in relation to goods with an intention to identify and determine the specific goods to be delivered under the contract. The distinction between 'ascertainment' and 'appropriation' is that whereas 'ascertainment' can be a unilateral act of the seller, that is, he alone may set apart the goods, 'appropriation' involves the element of mutual consent of the seller and the buyer.

Essentials of valid appropriation. The following points should be noted as regards a valid or proper appropriation of the goods:

(i) The appropriation must be of goods answering the contract description, both as to quality and quantity.

(ii) The appropriation must be intentional, *i.e.*, it must be made with intention to appropriate goods to specific contract, and it must not be due to mere accident or mistake.

(iii) The appropriation must be made either by the seller with the assent of the buyer or by the buyer with the assent of the seller. Assent of the other

[7]Future goods are always unascertained goods.

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party is thus necessary; whether before or after the appropriation is made; for a valid appropriation.

(iv) The appropriation must be unconditional, *i.e.*, the seller should not *reserve* to himself *the right of disposal of the goods* until and unless certain conditions are fulfilled.

Delivery to carrier [Sec. 23(2)]. A seller is deemed to have unconditionally appropriated the goods to the contract where he delivers the goods to a carrier or other bailee (whether named by the buyer or not) for the purpose of transmission to the buyer, and *does not reserve the right of disposal.* Thus delivery to a carrier without reserving the right of disposal is a delivery to the buyer and the property passes at once at the time of delivery to the carrier. *For example,* if goods have been loaded on rail and railway receipt is taken in the name of the buyer and the same is sent to him direct, the ownership is passed immediately on delivery to the railway company. But if the railway receipt, instead of sending direct to the buyer, is sent to the bank with instruction to deliver it to the buyer on payment of the price, the right of disposal is said to have been reserved and no property passes to the buyer on delivery to the railway company.

Reservation of right of disposal (Sec. 25). Reservation of the right of disposal means reserving a right to dispose of the goods until certain conditions (like payment of the price) are fulfilled. When the seller reserves such a right the property in the goods does not pass until those conditions are fulfilled. The seller may reserve such a right expressly while making a contract or while making appropriation of unascertained goods. He may also reserve this right by implication, for example, when the seller while transporting goods takes the railway receipt or the bill of lading in his own name or where the seller has taken the R/R or B/L in the name of the buyer but has delivered the same to his bank with the instructions that the document is to be delivered to the buyer only when he makes payment of the price or accepts the bill of exchange, the right of disposal is said to be reserved impliedly.

Rule of Transfer of Title on Sale

The general rule relating to the transfer of title on sale is that "the seller cannot transfer to the buyer of goods a better title than he himself has." If the title of the seller is defective the buyer's title will also be subject to the same defect. Section 27 also lays down to the same effect and provides that "where goods are sold by a person who is not the owner thereof and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had...." This rule is expressed by the maxim, "*nemo det quod non habet,*" which means that *no one can give what he has not got.*

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The general rule aims at protecting the interests of the true owner and is deemed necessary in the larger interest of society. So if a thief disposes of stolen property, the buyer acquires no title though he may have purchased the goods *bonafide* for value, and the real owner of the goods is entitled to recover possession of goods without paying anything to the buyer. Similarly, where a hirer of goods under a hire purchase agreement sells them before he had paid all the instalments, the buyer, though acting in good faith, does not acquire the property in the goods against the true owner and, on default of payment by the hirer, the true owner can recover the goods from the buyer (*Whiteley & Co.* vs *Hill*[8]).

Thus a buyer cannot get a good title to the goods unless he purchases the goods from a person who is the owner thereof or who sells them under the authority or with the consent of the owner.

Transfer of Title by Non-Owners

The above general rule as to title is subject to the following exceptions where the buyer gets a better title to the goods than what the seller himself possesses:

1. **An unauthorised sale by a mercantile agent** (Sec. 27). A mercantile agent means an agent having in the customary course of business as such agent authority either to sell goods, or to consign goods for the purposes of sale, or to buy goods, or to raise money on the security of goods [Sec. 2(9)]. Thus as a rule a mercantile agent *having an authority* to sell goods conveys a good title to the buyer. But by virtue of this provision (proviso to Sec.27) a mercantile agent can convey a good title to the buyer even though he sells goods *without having any authority* from the principal to do so, provided the following conditions are satisfied:

(a) he should be in possession of the goods or documents of title to the goods in his capacity as mercantile agent and with the consent of the owner,

(b) he should sell the goods while acting in the ordinary course of business,

(c) the buyer should act in good faith without having any notice, at the time of the contract, that the agent has no authority to sell.

ILLUSTRATION. *F* entrusted his car to a mercantile agent for sale at a stated price and not below that. The agent sold it to *S*, a *bonafide* purchaser, below the reserve price and misappropriated the proceeds. *S* resold the car to *K*, the defendant. *Held*, *S* obtained a good title to the car from the mercantile agent and he conveyed a good title to *K* and therefore *F* was not entitled to recover the car from *K* (*Folkes* vs *King*[9]).

2. **Transfer of title by estoppel** (Sec. 27). In the words of Lord

[8](1918), 2 K.B. 808.
[9](1923), 1 K.B. 282.

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Halsbury: "Estoppel arises when you are precluded from denying the truth of anything, which you have represented as a fact, although it is not a fact." Thus, estoppel means that a person who by his conduct or words leads another to believe that certain state of affairs existed, would be estopped from denying later on that such a state of affairs did not exist. The basis of estoppel is that it would be unfair or unjust to allow a party to depart from a particular state of affairs which he has permitted another person to believe to be true (*Central Newbury Car Auctions Ltd.* vs *Unity Finance Ltd.*[10]). Sometimes the doctrine of estoppel may estop or preclude the true owner from denying seller's right to sell the goods and thus an innocent buyer may have a good title despite the want of authority of the seller. When the true owner of the goods by his conduct or words or by any act or omission leads the buyer to believe that the seller is the owner of the goods or has the authority to sell them, he cannot afterwards deny the seller's authority to sell. The buyer in such a case gets a better title than that of the seller. In reference to sale of goods, estoppel may arise in any of the following ways:[11]

(i) The owner standing by, when the sale is effected, or

(ii) still more, by his assisting the sale, or

(iii) by permitting goods to go into the possession of another with all the insignia of possession thereof and apparent title, or

(iv) if he has otherwise acted or made representations so as to induce the buyer to alter his position to his prejudice.

ILLUSTRATION. *M*, the owner of a wagon allowed one of his employees *K*, to have his name painted on it. *M* did so for the purpose of inducing the public to believe that the wagon belonged to *K*. *C* purchased the wagon from *K* in good faith. *C* acquires a good title as *M* is estopped from denying *K*'s authority to sell (*O'Connor* vs *Clark*[12]).

3. **Sale by a joint owner** (Sec. 28). If one of several joint owners of goods has the sole possession of them by permission of the co-owners, the property in the goods is transferred to any person who buys them from such joint owner in good faith without notice of the fact that the seller has no authority to sell. It may be noted that in the absence of this provision (*i.e.*, Sec. 28) the buyer would have obtained only the title of the co-owners and would have become merely a co-owner with the other co-owners. Hence the provision constitutes an exception to the rule — "no one can give what he has not got."

ILLUSTRATION. *A*, *B* and *C* are three brothers. They own a cow in common. *B* and *C* entrust the work of looking after the cow to *A* and leave the cow in *A*'s

[10](1956), 3 All E.R. 904.
[11]Pollock and Mulla—*Sale of Goods Act and Partnership Act*, p. 120.
[12]170 Pa St. 318.

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possession. *A* sells the cow to *D*. *D* purchases *bonafide* for value. *D* gets a good title.

4. **Sale by person in possession under voidable contract** (Sec. 29). When a person has obtained possession of the goods under a voidable contract and he sells those goods before the contract has been rescinded, the buyer of such goods acquires a good title to them provided the buyer acts in good faith and without notice of the seller's defect of title. The Indian Contract Act also provides to the same effect when it lays down that the right to avoid a voidable contract exists only so long as the interests of a third person have not intervened. If before it is exercised the interests of a third person have intervened, *i.e.*, the buyer has sold the goods to a sub-buyer, the latter, if acting *bonafide* gets a good title and the original vendor cannot claim the goods back from the sub-buyer.

ILLUSTRATION. *A*, by misrepresentation induces *B* to sell and deliver to him a cow. *A* sells the cow to *C* before *B* has rescinded the contract. *C* purchases the cow in good faith and without notice of the seller's defective title. *C* acquires a good title.

It is to be noted that this Section (Sec. 29) does not apply unless there is a contract. Thus it does not apply to a contract originally void or where goods have been obtained by theft.

5. **Sale by Seller in possession after sale** [Sec. 30(1)]. Where a seller, after having sold the goods, continues to be in possession of the goods or of the documents of title to them and again sells or pledges them either himself or through a mercantile agent, he will convey a good title to the buyer or the pledgee provided the buyer or the pledgee acts in good faith and without notice of the previous sale. For the application of this exception it is essential that the possession of the seller must be as seller and not as hirer or bailee.

6. **Sale by buyer in possession after 'agreement to buy'** [Sec. 30(2)]. Where a buyer has agreed to buy the goods and has obtained possession of the same or the documents of title to them with the consent of the seller, resells or pledges the goods either himself or through a mercantile agent, he will convey a good title to the buyer or the pledgee provided the person receiving the goods acts in good faith and without notice of any lien or other right of the original seller in respect of those goods.

It is to be noted that a person who has got merely 'an option to buy,' as in a hire-purchase agreement, cannot convey a good title to a sub-buyer, however *bonafide,* for 'an option to buy' is not 'an agreement to buy' (*Belsize Motor Supply Co.* vs *Cox*[13]). In order to make this exception applicable it is essential that the person must have obtained possession of the goods under 'an agreement to sell' (*i.e.*, under 'an agreement to buy' from the buyer's point of view).

[13](1914),1 K.B. 244.

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ILLUSTRATIONS. *(a) A* buys some furniture and agrees to pay for that in two monthly instalments, the ownership to pass to him on payment of the second instalment. Having obtained possession of the furniture, *A*, sells the furniture to *B* before paying the second instalment. *B* buys the furniture *bonafide*.. Subsequently *A* does not pay the second instalment. The furniture dealer cannot take back furniture from *B*, who obtains a good title to the same. The dealer can, of course, sue *A* for the breach of the contract and claim damages.

(b) A agreed to buy a car and pay for it, if his solicitor approved. *A* obtained possession of the car and sold the same to *B*. But the solicitor subsequently disapproved of the transaction. It was held that *B*, the *bonafide* buyer, got a good title, because *A* agreed to buy (*Marten* vs *Whale*[14]).

7. **Resale by an unpaid seller** [Sec. 54(3)]. Where an unpaid seller, who has exercised his right of lien or stoppage in transit, resells the goods (of which ownership has passed to the buyer), the subsequent buyer acquires a good title thereto as against the original buyer, even though the resale may not be justified in the circumstances, *i.e.*, no notice of the resale has been given to the original buyer.

8. **Exceptions under other Acts.** Other Acts also contain some provisions under which a non-owner may pass to the buyer a better title than he himself has. For example,

(a) Sale by finder of lost goods under certain circumstances (Sec. 169, The Contract Act).[15]

(b) Sale by pawnee or pledgee under certain circumstances (Sec. 176, The Contract Act).[15]

(c) Sale by Official Receiver or Assignee in case of insolvency of an individual and Liquidators of companies. These persons are not owners of the properties they deal in, but convey a better (good) title to the buyers than they themselves possess.

(d) Under the Negotiable Instruments Act, a holder in due course gets a better title than what his endorser had. In other words, a person who takes a negotiable instrument in good faith and for value becomes the true owner even if he takes it from a thief or finder.

TEST QUESTIONS

1. Why is it important to know the exact time when the property in goods passes from a seller to buyer? Explain with examples the rules regarding the transfer of ownership of goods from seller to buyer.
2. State the rules in regard to the passing of property from a seller to a buyer in a contract for the sale of goods.
3. State the rules of ascertaining the intention of the parties as to the time when the property in the specific goods is to pass to the buyer.

[14](1917), 2 K.B. 480.
[15]For details refer to Chapter 14—*Bailment and Pledge.*

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4. What are rules as to the passing of property from a seller to a buyer in a contract for the sale of unascertained and future goods?

5. *(a)* "Risk *prima facie* passes with property." Comment.

(b) Explain what is meant by reservation of the right of disposal in sale of goods.

6. "*Nemo Det Quod Non Habet*" (No one can give what he has not got). Comment, giving exceptions to this rule. Illustrate your answer.

7. "A seller cannot convey a better title to the buyer than he himself has." Discuss this rule of law and point out the exceptions.

8. "No one can give a better title than what he himself possesses." Discuss this rule with reference to sale of goods.

9. Discuss the various provisions of law under which a non-owner can convey a good title to a buyer.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. *A* sells to *B* a horse which is to be delivered to *B* the next week. *B* is to pay the price on delivery. *A* asks his servant to keep the horse separate from other horses. The horse, however, dies before it is delivered and paid for. Who shall bear the loss?

[Hint. It is a contract of sale of specific goods in a deliverable state and therefore the property in the horse passes to *B* at once at the time of contract. Hence *B* should bear the loss].

2. On 6th May, *A* entered into a contract for the sale of 100 bags of wheat to *B* and received Rs 2,500 in part payment of the price. The goods were not with the seller at that time but had been despatched from Hapur on 4th May. *A* had received the R/R which he endorsed in favour of *B* on 6th May. The goods never reached the destination as they were burnt on 7th May while in transit. Who shall bear the loss?

[Hint. *B* has to bear the loss as the property in the goods had passed to him at once at the time of endorsement of the R/R in his name, *i.e.*,on 6th May while the loss occurred on 7th May].

3. *X* sells a car by auction to *Y*, who is the highest bidder. *Y* offers to pay for the car by a cheque and he is allowed to do so provided he signs a document stating that the property in the car would not pass to him until the amount of the cheque has been credited to the seller's account. The cheque is subsequently dishonoured. *X* asks *Y* to return back the car as he has not become the owner of the car because the cheque given by him has been dishonoured. Is *X*'s contention justified?

[Hint. No, *X*'s contention is not justified. The property in the car had passed on the fall of hammer, a subsequent agreement that the property would not pass until the cheque is realised is of no effect and therefore *X* having lost his title to the car cannot recover back the same from *Y*. *X*'s only remedy is to sue *Y* for the price. Delivery and payment are concurrent conditions. *X* was, therefore, entitled to refuse delivery of car until paid and could have exercised his 'right of lien' as an unpaid seller. But once he has given the delivery of car, his 'right of lien' is lost, since lien is lost once possession is lost.]

4. *A* sells to *B* the whole content of a certain heap of wheat, which according

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to *A* contains 10 quintals. *B* gets the wheat weighed for his own satisfaction. When the wheat is being weighed, there is a fire and the whole of the wheat is destroyed. Can *A* recover the price of wheat from *B*?

[Hint. Yes, *A* can recover the price from *B*. It is a contract of sale of specific goods in a deliverable state (as nothing remained to be done by the seller to ascertain the price), and, therefore, the property passes to the buyer as soon as the contract is made. When the buyer gets something done for his own satisfaction, the passing of property is not affected by that and Sec. 20 applies to such a case alright].

5. *A* gives some diamonds to *B* on sale or return basis. On the same day *B* gives those diamonds to *C* on sale or return and from him they are lost. Who shall bear the loss?

[Hint. *B* must bear the loss because by transferring the diamonds further he has adopted the transaction and the property in them has, therefore, passed to him].

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Chapter 19

Performance of Contract of Sale

"It is the duty of the seller to deliver the goods and of the buyer to accept and pay for them, in accordance with the terms of the contract of sale" (Sec. 31). Thus, the performance of a contract of sale implies *delivery of goods* by the seller and *acceptance of the delivery* of goods and *payment* for them by the buyer, in accordance with the contract. The parties are free to provide any terms they like in their contract about the time, place and manner of delivery of goods, acceptance thereof and payment of the price. But if the parties are silent and do not provide any thing regarding these matters in the contract then the rules contained in the Sale of Goods Act are applicable.

Delivery

Delivery of goods means *voluntary transfer of possession* of goods from one person to another [Sec. 2(2)]. If transfer of possession of goods is not voluntary, *i.e.*, possession is obtained under pistol point or by theft, there is no delivery.

Modes of Delivery

Delivery of goods may be made in any of the following ways:

1. **Actual delivery.** Where the goods are physically handed over by the seller (or his authorised agent) to the buyer (or his authorised agent), the delivery is said to be actual. For example, the seller of a car hands over the car to the buyer, there is actual delivery of the goods.

2. **Symbolic delivery.** Here the goods remain where they are (probably because they are bulky), but the *means of obtaining possession* of goods is delivered. For example, the seller hands over to the buyer the key of the godown where the goods are stored, or transfers a document of title (*i.e.*, bill of lading or railway receipt) to the buyer which will entitle him to obtain the goods.

3. **Constructive delivery or delivery by attornment.** Such a delivery takes place when the person in possession of the goods of the seller acknowledges, in accordance with the seller's order, that he holds the goods

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on behalf of the buyer and the buyer has assented to it. Note that in such a delivery all the three parties, namely, the seller, the person holding the seller's goods and the buyer, must concur. For example, where the seller hands over the 'delivery order' to the buyer and the warehouseman, who was holding the goods as a bailee of the seller, agrees and acknowledges to hold them on behalf of the buyer, there is a constructive delivery. Similarly, where the seller after selling the goods agrees to hold them on behalf of the buyer as his bailee there is deemed to be delivery of the goods to the buyer.

Rules as to Delivery of Goods

The rules regarding delivery of goods are as follows:

1. **Delivery may be either actual or symbolic or constructive** (Sec. 33). Delivery of goods sold may be made by doing anything which the parties agree shall be treated as delivery or which has the effect of putting the goods in the possession of the buyer or of any person authorised to hold them on his behalf. Thus, the delivery of the goods may be either *actual,* or *symbolic* or *constructive.* (These terms have already been explained under the preceding heading.)

2. **Delivery and payment are concurrent conditions** (Sec. 32). Unless otherwise agreed, delivery of the goods and payment of the price are *concurrent conditions,* that is, the seller should be ready and willing to deliver the goods to the buyer in exchange for the price and the buyer should be ready and willing to pay the price in exchange for possession of the goods simultaneously, just like in a cash sale over a shop counter.

ILLUSTRATION. *A* contracts to sell to *B* 10 bags of sugar for Rs 9,000. *A* need not deliver the goods unless *B* is ready and willing to pay for the goods on delivery, and *B* need not pay for the goods unless *A* is ready and willing to deliver them on payment.

3. **Effect of part delivery, when property in goods is to pass on delivery** (Sec. 34). A delivery of part of the goods, in progress of the delivery of the whole, has the same effect, for the purpose of passing the property in such goods, as a delivery of the whole. In other words, when a delivery of part of the goods has been made with the intention of delivering the rest also, the property in the whole of the goods is deemed to pass to the buyer as soon as some portion is delivered.

ILLUSTRATION. A ship arrives with a cargo consigned to *X*, the buyer of the cargo, upon the condition that the property is to pass to him on delivery. The captain begins to discharge it, and delivers over part of the goods to *X* in progress of the delivery of the whole. Here, the delivery of the portion of the goods to *X* is equivalent to the delivery of the whole of the cargo and the property in the whole of the goods passes to *X*, the buyer (*Dixon* vs *Yates*[1]).

[1]5B. & Ad. 313.

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But when a part of the goods is delivered with the intention of severing it from the whole, it is not regarded as delivery of the whole of the goods and the property is deemed to pass to the buyer in that portion of the goods only which has been delivered.

ILLUSTRATION. If in a contract for the sale of a stack of hay the buyer is permitted to remove only a part of it, this does not amount to delivery of the whole as it shows an intention to separate the part delivered from the rest of hay (*Bunnery* vs *Poyntz*[2]).

It may be emphasised that the above stated rules are applicable only when passing of property has been made dependent on delivery of the goods. It fact these rules are declaratory of the general law relating to transfer of property (which has already been discussed in the preceding chapter).

4. **Buyer to apply for delivery** (Sec. 35). Although it is the duty of the seller to deliver the goods according to the contract, yet he is not bound to deliver them until the buyer applies for delivery. It is the duty of the buyer to demand delivery, and if he fails to do so, he cannot blame the seller for the non-delivery. The parties may, however, agree otherwise.

5. **Time of delivery** [Sec. 36(2) & (4)]. Where under the contract of sale the seller is bound to send the goods to the buyer, but no time for sending them is fixed, the seller is bound to send them within a reasonable time. Further, demand of delivery by the buyer or the tender of delivery by the seller should be made at a reasonable hour. What is a reasonable hour is a question of fact.

6. **Place of delivery** [Sec. 36(1)]. The place of delivery may be stated in the contract of sale, and where it is so stated, the goods must be delivered at the named place during business hours on a working day. But where no place is mentioned in the contract, the following rules must be followed:

(*i*) In the case of 'sale,' the goods are to be delivered at the place at which they are at the time of the sale.

(*ii*) In "an agreement to sell," the goods are to be delivered at the place where they are at the time of the agreement to sell.

(*iii*) In the case of future goods, the goods are to be delivered at the place at which they are manufactured or produced.

Where the seller of goods agrees to deliver them at his own risk at a place other than that where they are when sold, the buyer must, nevertheless, unless otherwise agreed, take any risk of deterioration in the goods necessarily incidental to the course of transit (Sec. 40).

7. **Delivery of goods where they are in possession of a third party** [Sec. 36(3)]. Where the goods at the time of sale are in the possession of a third person, there is no delivery by the seller to the buyer unless and until such third person acknowledges to the buyer that he holds the goods on his

[2](1833), 4 B. & Ad. 568.

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behalf. Such a delivery is known as "constructive delivery" or "delivery by attornment" and requires the consent of all the three parties, the seller, the buyer and the person having possession of the goods. Where the seller hands over the 'delivery order' to the buyer, there is no delivery unless the seller's agent holding the goods has assented thereto.

But where the goods have been sold by the transfer of the document of title to goods, *e.g.,* railway receipt or bill of lading, the buyer is deemed to be in possession of the goods represented by such document, and the assent of the third party is not required.

8. **Expenses of delivery** [Sec. 36(5)]. Unless otherwise agreed, the expenses of and incidental to putting the goods into a deliverable state must be borne by the seller.

9. **Delivery of wrong quantity or different quality** (Sec. 37). As already observed, a seller is duty bound to deliver the goods to the buyer strictly in accordance with the terms of the contract. A defective delivery, *i.e.*, delivery of a *quantity less or more* than that contracted for *or* delivery of goods *mixed with the goods of a different description* not included in the contract, entitles the buyer:

(*i*) to reject the whole, or

(*ii*) to accept the whole, or

(*iii*) to accept the quantity and quality he ordered and reject the rest of the goods so delivered.

Remember that in case of rejection of goods because of defective delivery the buyer is not bound to return them to the seller, but it is sufficient if he intimates to the seller that he refuses to accept them (Sec. 43). Further, the right to reject the goods is not equivalent to right to cancel the contract. If the buyer rejects the goods, the seller has a right to tender again goods of contract quality and quantity subject to the terms and conditions of the contract and the buyer is bound to accept the same (*Vilas Udyog Ltd.* vs *Prag Vanaspati*[3]).

Where the buyer accepts the goods, he must pay for what he has actually accepted, at the contract rate. In case the buyer has accepted short delivery he is entitled to claim damages for the same from the seller. If, however, the deficiency or excess is so small as to be negligible, the court does not take account of that, and the buyer must accept the goods. This is based on the *maxim* that "the law does not take trivial deviations into account."

The above provisions are subject to any usage of trade, special agreement or course of dealing between the parties [Sec. 37(4)].

10. **Instalment deliveries** (Sec. 38). Unless otherwise agreed, the buyer

[3]A.I.R. (1975), Guj. 112.

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of goods is not bound to accept delivery thereof by instalments. If the parties so agree then only the delivery of the goods may be made by instalments.

When the parties agree that the delivery is to be made by instalments and each instalment is to be separately paid for, and either buyer or seller commits a breach of contract in respect of one or more instalments, there arises a question as to whether such a breach amounts to a breach of the whole of the contract or a breach of only a part of it? The answer to this question depends upon the terms of the contract and the circumstances of the case. Unless otherwise agreed the following two factors must be borne in mind in deciding the whole matter:

(*a*) The quantitative proportion which the breach bears to the contract as a whole, and

(*b*) the degree of probability of the repetition of the breach (*Maple Flock Co. Ltd.* vs *Universal Furniture Products Ltd.*[4]).

Generally, failure to deliver or pay for one instalment does not amount to a breach of the whole contract, unless from the special circumstances of the case (*e.g.*, the factory is closed because of a labour strike or the buyer becomes insolvent) it can be inferred that similar breaches will be repeated.

ILLUSTRATION. *A* sold to *B* 1,500 tons of meat of a specified quality to be shipped 125 tons monthly in equal weekly instalments. After about half the meat was delivered and paid for, *B* discovered that it was not of the contract quality and could have been rejected, and therefore he refused to take further deliveries. *Held*, that *B* was entitled to do so (*Robert A. Munroe & Co. Ltd.* vs *Meyer*[5]). (If *B* might have discovered the defect just after first instalment, he would not have been allowed to repudiate the whole contract but only the damages for the loss in that particular instalment delivery would have been allowed).

11. **Delivery to carrier or wharfinger** (Sec. 39). Where the seller is authorised or required to send the goods to the buyer , delivery of the goods to a carrier, whether named by the buyer or not, for the purpose of transmission to the buyer, *or* delivery of the goods to a wharfinger for safe custody, is *prima facie* deemed to be a delivery of the goods to the buyer.

Seller's duty. Unless the buyer requires to despatch the goods at owner's risk, it is the duty of the seller, when he delivers the goods to the carrier or wharfinger, to enter into a reasonable contract on behalf of the buyer for the safety of the goods, and if he fails to do so, and the goods are lost or damaged, the buyer may decline to treat the delivery to the carrier or wharfinger as a delivery to himself, or may hold the seller responsible in damages.

Sea transit. Unless otherwise agreed, where goods are sent by the seller

[4](1934), 1 K.B. 148.
[5](1930), 2 K.B. 312.

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to the buyer by a route involving sea transit, where it is usual to insure, the seller must inform the buyer in time to get the goods insured during their sea transit, and if the seller fails to do so, the goods shall be deemed to be at his risk during such sea transit.

12. **Liability of buyer for neglecting or refusing to take delivery of goods.** (Sec. 44). When the seller is ready and willing to deliver the goods and requests the buyer to take delivery, and the buyer does not within a reasonable time after such request take delivery of the goods, he becomes liable to the seller for any loss occasioned by his neglect or refusal to take delivery, and also for a reasonable charge for the care and custody of the goods.

Acceptance of Delivery by Buyer

The mere fact that the buyer has taken the delivery of the goods does not amount to acceptance of them. According to Section 42, the buyer is deemed to have accepted the goods in either of the following circumstances, namely:

1. When he intimates to the seller that he has accepted the goods.

Before intimating about acceptance the buyer has a right, under Section 41, to examine and test the goods in order to be sure as to whether they are in conformity with the contract regarding quality *etc.* He may even use the goods, if it is necessary for the purpose of testing, *e.g.*, in the case of a horse sale conditioned to run at 25 kilometers per hour it is necessary to use the horse for ascertaining, whether the horse is in conformity with the contract. But if he is not satisfied, he must act promptly to inform the seller about rejection.

2. When he does any act in relation to the goods which is inconsistent with the ownership of the seller, *e.g.*, consumes, uses, pledges or resells the goods or puts his mark on them.

ILLUSTRATIONS. (*a*) Where the buyer having seen that samples drawn from bulk were inferior to the samples originally shown to him, offered the goods for sale by auction at reduced price and the auction having failed to produce a purchaser, the buyer purported to reject the goods, it was *held* that the buyer could not do so as he had in law 'accepted' the goods (*Parker* vs *Palmer*[6]).

(*b*) Where the buyer took delivery of wheat and sold a part of it, and afterwards found that the wheat was not of contract quality and therefore sought to reject it, it was *held* that he had lost the right of rejection as he had accepted the wheat by a dealing inconsistent with the rights of the seller, in so far as he had sold out a portion of it (*Hardy & Co.* vs *Hillerns and Fowler*[7]).

3. When, after the lapse of a reasonable time, he retains the goods

[6]4 B. & Ad. 387.
[7](1923), 2 K.B. 490.

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without intimating the seller that he has rejected them. What is reasonable time is a question of fact. If time for rejection is stipulated, rejection must be within that period. It may be mentioned that on rejection of goods because of defective delivery, mere informing the seller is enough and the buyer is not bound to return the rejected goods to the seller (Sec. 43).

TEST QUESTIONS

1. Define the term 'delivery' as used in a contract of sale and discuss the rules relating to delivery of goods.
2. "It is the duty of the seller to deliver the goods and of the buyer to accept and pay for them in accordance with the terms of the agreement," Elucidate.
3. (*a*) State the rights of a buyer in case of (*i*) short delivery, (*ii*) delivery in excess of contract quantity, and (*iii*) delivery of contract goods mixed with other goods.

(*b*) "Delivery does not amount to acceptance of goods." Comment.

4. Enumerate the rights and duties of the buyer in respect of the sale of goods.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* sells to *B* 100 bags of wheat which are locked up in a godown. *A* hands over to *B* the key of the godown. Does it constitute delivery of the goods to *B*?

[**Hint.** Yes, this is a delivery to *B*, being a symbolic delivery.]

2. *X* of Cochin agreed to sell 400 tons of rice to *Y* of Calcutta to be shipped in November or December 1985. *X* puts the rice on ship on 20 October 1985. Is the buyer bound to accept the consignment?

[**Hint.** The buyer is not bound to accept the consignment because the seller has not complied with the stipulation as to time and time being of the essence of all mercantile contracts, an essential term of the contract has been broken.]

3. *P* of Delhi writes to *R* of Bombay to send him a book by parcel post. *R* accordingly sends the book by parcel post. The parcel is lost on the way. Can *R* recover its price from *P*?

[**Hint.** Yes, *R* can recover the price of the book from *P* because as per Section 39 of the Sale of Goods Act, delivery to the carrier (*i.e.*, the post office) is delivery to the buyer and the buyer becomes the owner thereafter who should bear the loss.]

4. *P* sold barley to *B* by sample, delivery to be made at *T* railway station. *B* sold the barley to *X*. The barley was delivered at *T* railway station and *B*, after inspecting a sample of it, sent it on to *X*. *X* rejected it as not being according to sample, whereupon *B* seeks to reject the goods. Will *B* succeed?

[**Hint.** *B* cannot reject the barley, as by reselling those goods to *X* and ordering to send them to *X*, he had in law 'accepted' the goods.]

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Chapter 20

Remedial Measures

RIGHTS OF UNPAID SELLER

Unpaid Seller Defined

The seller of goods is deemed to be an 'unpaid seller' *(a)* when the *whole* of the price has not been paid or tendered; or *(b)* where a bill of exchange or other negotiable instrument has been received as a conditional payment, *i.e.*, subject to the realisation thereof, and the same has been dishonoured.

The term 'seller' here includes any person who is in the position of a seller, as, for instance, an agent of the seller to whom the bill of lading had been endorsed, *or* a consignor or agent who has himself paid, or is directly responsible for, the price. (Sec. 45)

This definition emphasises the following characteristics of an 'unpaid seller':

1. He must sell goods on cash terms and not on credit, and he must be unpaid.

2. He must be unpaid either wholly or partly. Even if only a portion of the price, however small, remains unpaid, he is deemed to be an unpaid seller. Where the price is paid through a bill of exchange or other negotiable instrument, the same must be dishonoured.

3. He must not refuse to accept payment when tendered. If the price has been tendered by the buyer but the seller wrongfully refuses to take the same, he ceases to be an unpaid seller.

Rights of an Unpaid Seller

An unpaid seller has two-fold rights, *viz.*,:

I. Rights of unpaid seller against the goods, and

II. Rights of unpaid seller against the buyer personally.

We shall now examine these rights in detail.

I. Rights of Unpaid Seller against the Goods

An unpaid seller has the following rights against the goods notwith-

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standing the fact that the property in the goods has passed to the buyer:

1. Right of lien;
2. Right of stoppage of goods in transit;
3. Right of resale [Sec. 46(1)].

1. **Right of lien** (Sec. 47)

'Lien' is the right to retain possession of goods and refuse to deliver them to the buyer until the price due in respect of them is paid or tendered. An unpaid seller in possession of goods sold is entitled to exercise his lien on the goods in the following cases:

(*a*) where the goods have been sold without any stipulation as to credit;

(*b*) where the goods have been sold on credit, but the term of credit has expired:

(*c*) where the buyer becomes insolvent,[1] even though the period of credit may not have yet expired.

In the case of buyer's insolvency the lien exists even though goods had been sold on credit and the period of credit has not yet expired. When the goods are sold on credit the presumption is that the buyer shall keep his credit good. If, therefore, before payment the buyer becomes insolvent, the seller is entitled to exercise this right and hold the goods as security for the price. The effect of buyer's insolvency is that all stipulations as to credit are put to an end and the seller has a right to say, "I will not deliver the goods until I see that I shall get my price paid" (*Griffiths* vs *Perry*[2]).

The unpaid seller's lien is a possessory lien, *i.e.*, the lien can be exercised as long as the seller remains in possession of the goods. He may exercise his right of lien notwithstanding that he is in possession of the goods as agent or bailee for the buyer [Sec. 47(2)]. Transfer of property in the goods or transfer of documents of title to the goods[3] does not affect the exercise of this right, provided the goods remain in the actual possession of the seller. In fact when property has passed to the buyer then only retaining of goods is called technically 'lien.' Where the property in goods has not passed to the buyer and the title is still with the seller then it is, strictly speaking, anomalous to say that the seller has a lien against his own goods. The seller's lien when property has not passed to the buyer is termed as '*a right of withholding delivery.*' Accordingly, Section 46(2) provides:

[1]The term *insolvent* here does not mean a person who has been adjudged insolvent under the Insolvency Law. In Sale of Goods Act "a person is said to be *insolvent* who has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, whether he has committed an act of insolvency or not" [Sec. 2(8)].

[2](1859), 1 E. & E. 680.

[3]But if the buyer has transferred the documents of title to a *bonafide* purchaser, the seller's lien is defeated (Sec.53).

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"Where the property in goods has not passed to the buyer, the unpaid seller has, in addition to his other remedies, a right of withholding delivery similar to and coextensive with his rights of lien and stoppage in transit where the property has passed to the buyer."

This right of lien can be exercised only for the non-payment of the price and not for any other charges, *e.g.*, maintenance or custody charges, which the seller may have to incur for storing the goods in exercise of his lien for the price.[4] This right of lien extends to the whole of the goods in his possession even though part payment for those goods has already been made. In other words the buyer is not entitled to claim delivery of a portion of the goods on payment of a proportionate price. Further, where an unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless such part delivery has been made under such circumstances as to show an agreement to waive the lien (Sec.48). Also, the lien can be exercised even though the seller has obtained a 'decree' for the price of the goods [Sec. 49(2)].

When lien is lost? As already observed, lien depends on physical possession of goods. Once the possession is lost, the lien is also lost. Section 49 accordingly provides that the unpaid seller of goods loses his lien thereon in the following cases:

(*a*) when he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the goods; or

(*b*) when the buyer or his agent lawfully obtains possession of the goods; or

(*c*) when the seller expressly or impliedly waives his right of lien. An implied waiver takes place when the seller grants fresh term of credit or allows the buyer to accept a bill of exchange payable at a future date or assents to a sub-sale[5] which the buyer may have made.

It may be noted that right of lien, if once lost, will not revive if the buyer redelivers the goods to the seller for any particular purpose. Thus, where a refrigerator after being sold was delivered to the buyer and since it was not functioning properly, the buyer delivered back the same to the seller for repairs, it was held that the seller could not exercise his lien over the refrigerator (*Eduljee* vs *John Bros.*[6]).

2. Right of Stoppage of Goods in Transit

The right of stoppage in transit means the right of *stopping further*

[4]Section 46 (1) (a) and 47 (1).
[5]Section 53 (1).
[6]A.I.R. (1943), Nag. 249.

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transit of the goods while they are with a carrier for the purpose of transmission to the buyer, resuming possession of them and retaining possession until payment or tender of the price. Thus, in a sense this right is an extension of the right of lien because it entitles the seller to regain possession even when the seller has parted with the possession of the goods.

When can this right be exercised? (Sec. 50). An unpaid seller can exercise this right only when:

(*a*) *the buyer becomes insolvent.* The buyer is said to be insolvent when he has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, whether he is declared an insolvent or not [Sec. 2(8)]; and

(*b*) *the property has passed to the buyer.* If property has not passed to the buyer then this right is termed as the "right of withholding delivery" [Sec. 46(2)]; and

(*c*) *the goods are in the course of transit.* This means that goods must be neither with the seller nor with the buyer nor with their agent. They should be in the custody of a carrier as an *independent middleman* (*i.e.*, in his own right as a carrier) *e.g.*, railways and common carriers whose business is to transport goods of others. The carrier must not be either seller's agent or buyer's agent. Because if he is seller's agent, the goods are still in the hands of seller in the eye of law and hence there is no transit, and if he is buyer's agent, the buyer gets delivery in the eye of law and hence question of stoppage does not arise.

Duration of transit (Sec. 51). Since the right of stoppage in transit can be exercised only so long as the goods are in the course of transit, it becomes necessary to know as to when the transit begins and when it comes to an end. When the transit comes to an end the right of stoppage cannot be exercised.

According to Section 51, goods are deemed to be in course of transit from the time when they are delivered to a carrier or other bailee for the purpose of transmission to the buyer, until the buyer or his agent takes delivery of them. Thus the transit continues so long as the goods are not delivered to the buyer or his agent, no matter whether they are lying at the destination with the carrier awaiting transmission or are in actual transit. The goods are still deemed to be in transit if they are rejected by the buyer and the carrier or other bailee continues in possession of them, even if the seller has refused to receive them back.

The transit is deemed to be at an end and the seller cannot exercise his right of stoppage in the following cases:

(*a*) When the buyer or his agent takes delivery after the goods have reached destination.

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(*b*) When the buyer or his agent obtains delivery of the goods before their arrival at the appointed destination.

(*c*) When the goods have arrived at their destination and the carrier acknowledges to the buyer or his agent that he holds the goods on his behalf.

(*d*) When the goods have arrived at their destination but the buyer instead of taking delivery requests the carrier to carry the goods to some further destination and the carrier agrees to take them to the new destination.

(*e*) When the carrier wrongfully refuses to deliver the goods to the buyer or his agent.

(*f*) When part delivery of the goods has been made to the buyer with an intention of delivering the whole of the goods, transit will be at an end for the remainder of the goods also which are yet in the course of the transit.

How right of stoppage is exercised (Sec. 52). The unpaid seller may exercise his right of stoppage in transit either:

(*a*) by taking actual possession of the goods, or

(*b*) by giving notice of his claim to the carrier or other bailee in whose possession the goods are.

Such notice may be given either (*a*) to the person in actual possession of the goods, or (*b*) to his principal. In the latter case, notice must be given well in advance to enable the principal to communicate with his agent or servant in time, so as to prevent delivery to the buyer.

It is the duty of the carrier, after receiving due notice, not to deliver the goods to the buyer but to redeliver them to, or according to the directions of the seller. If by mistake he delivers the goods to the buyer, he can be made liable for conversion. The expenses of redelivery are to be borne by the seller.

Lien and Stoppage in Transit Distinguished

The main points of distinction between these two rights of an unpaid seller are as follows:

1. The seller's lien attaches when the buyer is in default, whether he be solvent or insolvent. The right of stoppage in transit arises only when the buyer is insolvent.

2. Lien is available only when the goods are in actual possession of the seller while right of stoppage is available when the seller has parted with possession and the goods are in the custody of an independent carrier.

3. The right of lien comes to an end once the seller hands over the possession of the goods to the carrier for the purpose of transmission to the

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buyer. On the other hand, the right of stoppage in transit commences after the seller has delivered the goods to a carrier for the purposes of transmission to the buyer and continues until the buyer has acquired their possession.

4. The right of lien consists in retaining the possession of the goods while the right of stoppage consists in regaining possession of the goods.

Effect of Sub-sale or Pledge by Buyer upon the "Two Rights of the Unpaid Seller" Discussed Above (Sec. 53)

The unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods which the buyer might have made. For example, *P* sells certain goods to *R* and delivers them to a carrier for transmission to *R*. Before the goods reach their destination *P* comes to know that *R* has become insolvent. In the meanwhile *R* sells those goods to *Q*. The sale of goods between *R* and *Q* will not affect the right of *P* to stop them in transit.

But there are two *exceptional cases* when these two rights of the unpaid seller are affected by a sale or other disposition of the goods by the buyer. These exceptions are:

(*i*) When the seller has assented to the sale or other disposition which the buyer may have made.

(*ii*) When a document of title to goods (*e.g.*, a bill of lading or railway receipt) has been issued or transferred to a buyer, and the buyer transfers the document to a person who takes the document in good faith and for consideration, then,

(*a*) if such last mentioned transfer was by way of sale, the unpaid seller's right of lien or stoppage in transit is defeated, and

(*b*) if such last mentioned transfer was by way of pledge, the unpaid seller's right of lien or stoppage in transit can only be exercised subject to the rights of the pledgee. But in this case the unpaid seller may require the pledgee to satisfy his claim against the buyer first out of any other goods or securities of the buyer in the hands of the pledgee.

3. **Right of Resale**

The right of resale is a very valuable right given to an unpaid seller. In the absence of this right, the unpaid seller's other rights against the goods, namely, 'lien' and 'stoppage in transit,' would not have been of much use because these rights only entitle the unpaid seller to retain the goods until paid by the buyer. If the buyer continues to remain in default, then should the seller be expected to retain the goods indefinitely, specially when the goods are perishable? Obviously, this cannot be the intention of

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the law. Section 54, therefore, gives to the unpaid seller *a limited right to resell* the goods in the following cases:

(*a*) where the goods are of a perishable nature; or

(*b*) where such a right is expressly reserved in the contract in case the buyer should make a default; or

(*c*) where the seller has given a notice to the buyer of his intention to resell and the buyer does not pay or tender the price within a reasonable time.

If on a resale there is a loss to the seller, he can recover it from the defaulting buyer. But if there is a surplus on the resale, the seller can keep it with him because the buyer cannot be allowed to take advantage of his own wrong. If, however, no notice of resale [as required in case *(c)* above] is given to the buyer, the right of seller to claim loss and retain surplus, if any, is reversed. In other words, if the unpaid seller fails to give notice of resale to the buyer, where *neither* the goods are of perishable nature *nor* such a right was expressly reserved, he cannot recover the loss from the buyer and is under an obligation to hand over the surplus, if any, to the buyer, arising from the resale. Thus, it will be seen that *giving of notice to the buyer,* when so required, is very necessary to make him liable for the breach of contract. It is so because such a notice gives an opportunity to the buyer either to pay the price and have the goods, or, if he cannot pay, to supervise the sale to see that the same is properly made.

It is important that absence of notice, when so required, affects the rights of the unpaid seller himself only as discussed above and it does not affect the title of the subsequent buyer who will acquire a good title to the goods. Section 54(3) specially declares—"Where an unpaid seller who has exercised his right of lien or stoppage in transit resells the goods, the buyer acquires a good title thereto as against the original buyer, notwithstanding that no notice of the resale has been given to the original buyer."

II. Rights of Unpaid Seller against the Buyer Personally

The unpaid seller, in addition to his rights against the goods as discussed above, has the following three rights of action against the buyer personally:

1. **Suit for price** (Sec. 55). Where property in goods has passed to the buyer; or where the sale price is payable 'on a day certain', although the property in goods has not passed; and the buyer wrongfully neglects or refuses to pay the price according to the terms of the contract, the seller is entitled to sue the buyer for price, irrespective of the delivery of goods.

2. **Suit for damages for non-acceptance** (Sec. 56). Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller

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may sue him for damages for non-acceptance. The seller's remedy in this case is a suit for damages rather than an action for the full price of the goods.

The damages are calculated in accordance with the rules contained in Section 73 of the Indian Contract Act, that is, the measure of damages is the estimated loss arising directly and naturally from the buyer's breach of contract. Where the goods have a ready market the principle applicable is that the seller may recover from the buyer damages equal to the difference between the contract price and the market price on the date of the breach of the contract. Thus, if the difference between the contract price and market price is nil, the seller can get only nominal damages (*Charter* vs *Sullivan*[7]). But where the goods do not have any ready market, the measure of damages will depend upon the facts of each case. For example, in *Thompson Ltd.* vs *Robinson*[8] the damages were assessed on the basis of profits lost. In that case, *T Ltd.,* who were car dealers, contracted to supply a motorcar to *R. R* refused to accept delivery. It was found as a fact that the supply of cars exceeded the demand at the time of breach and hence in a sense there was no market price on the date of breach. *Held, T Ltd.,* were entitled to damages for the loss of their bargain *viz.*, the profit they would have made, as they had sold one car less than they otherwise would have sold. To take another illustration, if the goods have been manufactured to some special order and they are unsaleable and have no value at all for other buyers, then the seller may even be allowed the full price of the goods as damages.

3. **Suit for special damages and interest** (Sec. 61). This Section entitles the seller to sue the buyer for 'special damages' also for such loss "which the parties knew, when they made the contract, to be likely to result from the breach of it." In fact the Section is only declaratory of the principle regarding 'special damages' laid down in Section 73 of the Indian Contract Act. The Section also recognises unpaid seller's right to get interest at a reasonable rate on the total unpaid price of the goods sold, from the time it was due until it is actually paid.

BUYER'S RIGHTS AGAINST SELLER

The buyer has the following rights against the seller for breach of contract:

1. **Suit for damages for non-delivery** (Sec. 57). Where the seller wrongfully neglects or refuses to deliver the goods to the buyer, the buyer

[7](1957), 2 Q.B. 117.
[8](1955), Ch. 177.

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may sue the seller for damages for non-delivery.

The damages are assessed in accordance with the rules contained in Section 73 of the Indian Contract Act, that is, the measure of damages shall be the estimated loss directly and naturally resulting, in the ordinary course of events, from the seller's breach of contract. If the goods in question have a ready market the measure of damages is *prima facie* to be ascertained by the difference between the contract price and market price on the date of breach. Section 61 entitles the buyer to sue the seller for 'special damages' also for such loss which the seller knew when they made the contract to be likely to result from the breach of it.[9]

ILLUSTRATION.[10] *A*, having contracted with *B* to supply *B* with 1,000 tons of iron at Rs 100 a ton, to be delivered at a stated time, contracts with *C* for the purchase of 1,000 tons of iron at Rs 80 a ton, telling *C* that he does so for the purpose of performing his contract with *B*. *C* fails to perform his contract with *A*, who cannot procure other iron, and *B* in consequence rescinds the contract. *C* must pay to *A* Rs 20,000 being the profit which *A* would have made by the performance of his contract with *B*.

2. **Suit for specific performance** (Sec. 58). Where there is breach of a contract for the sale of specific or ascertained goods, the buyer may file a suit for the specific performance of the contract. This remedy is discretionary and will only be granted when damages would not be an adequate remedy, for instance, the subject-matter of the contract is rare goods, say, a picture by a dead painter.

3. **Suit for damages for breach of warranty** (Sec. 59). Where there is a breach of warranty by the seller, or where the buyer elects or is compelled to treat breach of condition as breach of warranty, the buyer is entitled to file a suit for damages if the price has already been paid. But if the buyer has not yet paid the price he may ask the seller for a reasonable reduction in price.

Here also damages are to be ascertained in accordance with the provisions of Section 73 of the Indian Contract Act. Thus, the loss arising directly and naturally from the breach, *i.e.*, the difference between the value of the goods as delivered, and the value they would have had if the goods had answered to the warranty, can be recovered.

4. **Suit for rescission of contract and for damages for breach of 'condition'**. The breach of 'condition' entitles the buyer to treat the contract as repudiated [Sec. 12(2)]. Accordingly, where there is a breach of 'condition' by the seller, the buyer is entitled to file a suit for rescission of

[9]'Special damages' are also allowed under Section 73 of the Indian Contract Act.

[10]Illustration (j) to Section 73 of the Indian Contract Act.

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the contract. Also, he may claim damages for loss suffered on the footing that the whole contract is broken and the seller is guilty of non-delivery (*Millar's Machinery Co. Ltd.* vs *David Way & Son*[11]).

5. **Suit for recovery of the price together with interest** (Sec. 61). If the buyer has already paid the price of the goods to the seller and the goods are not delivered or they are stolen one, he can sue the seller for the refund of the price and also for the interest at reasonable rate from the date of payment to the date of refund.

AUCTION SALE

In an auction sale, the auctioneer invites bids from prospective purchasers and sells the goods to the highest bidder. Section 64 lays down the following rules relating to an auction sale:

1. Where goods are put up for sale in lots, each lot is *prima facie* deemed to be the subject of a separate contract of sale.

2. The sale is complete when the auctioneer announces its completion by the fall of the hammer or in other customary manner, say, by saying words like "one, two, three" or "going, going, gone;" and, until such announcement is made, any bidder may retract his bid. On the other hand, the auctioneer is also not bound to accept the highest bid if he feels that it is much below his expectation. Of course, his not accepting the highest bid would injure his business reputation because it is the custom of trade that goods must be sold to the highest bidder.

In the language of the Contract Act, a notice or advertisement of an auction sale is simply 'an invitation to an offer.' The bid constitutes the 'offer,' and the fall of hammer constitutes the 'acceptance.' An offer can always be withdrawn before its acceptance, and need not necessarily be accepted. In this connection, it may be of interest to note that the auctioneer has the right to make the auction subject to any conditions he likes (*The Coffee Board* vs *Famous Coffee and Tea Works*[12]). Thus, if the auctioneer expressly announces that biddings once made cannot be withdrawn, then that will hold good and the normal contractual rule, *i.e.*, an offer may be revoked before its acceptance will not apply.

3. The seller or any *one* person on his behalf can bid at the auction, provided such a right to bid has been expressly reserved at the time of notifying the auction sale. (The employment of a second puffer is fraudulent even if the right to bid is expressly reserved). If the seller makes use

[11](1934), 40 Com. Cas. 204.
[12](1965), A.I.R. Mad. 14.

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of pretended bidding to raise the price without expressly notifying about the same, the sale may be treated as fraudulent by the buyer and he may avoid the contract on that ground.

4. The sale may be notified to be subject to a *reserved or upset* price. It is a price below which the auctioneer will not sell, and if he by mistake knocks down the lot for less than the reserved price, no valid contract comes into existence and he can refuse to deliver the goods to the highest bidder (*Rainbow* vs *Hawkins*[13]). Where the sale is 'without reserve' the goods must be sold to the highest bidder, irrespective of the bid amount. But it is only a usage or custom of the trade because otherwise the auctioneer is free to accept or reject any offer or bid made to him.

5. A 'knock out' agreement between intending buyers not to bid against each other is not illegal (*Lachman Dass & Others* vs *Sita Ram & Others*[14]).

6. The auctioneer cannot sell goods on credit or accept payment by means of a bill of exchange. Also, he cannot be compelled to accept a cheque for the purchase price.

TEST QUESTIONS

1. Who is an unpaid seller of goods and what are his rights against the goods? Has he any remedy against the buyer personally?
2. Define unpaid seller. What are his rights under the Sale of Goods Act?
3. What is meant by an unpaid seller? Explain the nature of the right of lien and the right of stoppage of goods in transit of an unpaid seller. How are these rights affected by a sub-sale or pledge by the buyer?
4. What is meant by the unpaid seller's right of stoppage of goods in transit? Show how it differs from the unpaid seller's lien.
5. Distinguish between an unpaid seller's lien and stoppage of goods in transit. When can the unpaid seller resell the goods?
6. Discuss the remedies available to a buyer against the seller for breach of contract.
7. State the rules regarding sale by auction.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:-

1. *A* sells goods to *B*. *B* pays to *A* through a cheque. Before *B* could obtain the delivery of goods, his cheque has been dishonoured by the bank. *A*, therefore, refuses to give delivery of the goods until paid. Is *A*'s action justified?

[13](1904), 2 K.B. 322.
[14]A.I.R. (1975), Delhi, 159.

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[**Hint**. Yes, *A*'s action is justified, because the right of lien is linked with possession and not with title or passing of property.]

2. *A* sells goods to *B* and transfers him the document of title to the goods. *B* pays *A* through a cheque. In fulfilment of a contract of sale *B* transfers that document of title to *C*. Before *C* could obtain the delivery of goods, *B*'s cheque has been dishonoured by the bank. Hence *A* gives instructions to stop delivery of the goods to *C* until paid. Is *A*'s action justified?

[**Hint**. No, *A*'s action is not justified. An unpaid seller's right of lien if defeated against transferee who takes a document of title in good faith and for consideration (Sec. 53).]

3. *A* sells and consigns to *B* goods of the value of Rs 10,000 on credit. *B* assigns the railway receipt to *C* to secure a specific advance of Rs 5,000 on the railway receipt. Before the goods reach the destination *B* becomes insolvent. *A* gives notice to stop the goods in transit but *C* claims them. Can *A* stop the goods in transit?

[**Hint**. Yes, *A* can stop the goods in transit but subject to the pledge of *C*. *C* can recover the amount of pledge from the goods or from *A*. Hence *A* can stop the goods in transit only when he pays Rs 5,000 to *C* (Sec. 53).]

4. *P* sells to *R* a quantity of wheat lying in *P's* warehouse. It is agreed that three months' credit shall be given to *R*. *R* allows the wheat to remain in *P*'s warehouse. Before the expiry of the three months *R* becomes insolvent and the Official Assignee demands delivery of the wheat from *P* without offering to pay the price. Is *P* entitled to retain the goods until paid?

[**Hint**. Yes, *P* is entitled to retain the goods as security for the price until he is paid. In the case of buyer's insolvency the lien exists even though goods had been sold on credit and the period of credit has not yet expired, provided the goods are still in possession of the seller (Sec. 47).]

5. *A* sells certain goods to *B*, the property in the goods is to pass to *B* on delivery which is to take place on 1st August 1987, and the payment to be made by *B* on 1st June 1987. *B* refuses to pay the price on the due date on the plea that the property in the goods has not passed to him. Can *A* sue *B* for the price before the delivery of the goods takes place?

[**Hint.** Yes, *A* can sue *B* for the price. where the sale price is payable 'on a day certain,' the seller can sue the buyer on his default, irrespective of passing of property and delivery of goods (Sec. 55).]

6. *A* attended an auction sale and made a bid of Rs 600 for a typewriter but withdrew the offer before the fall of the hammer. One of the conditions of the sale, which *A* had read was that biddings once made, shall not be withdrawn. *A* was sued for Rs 600, his being the highest bid. Decide.

[**Hint.** *A* is liable to pay Rs 600 because as per the conditions of the auction no bid can be withdrawn. The auctioneer has the right to make the auction subject to any conditions he likes (*The Coffee Board* vs *Famous Coffee and Tea Works*, A.I.R. 1965 Mad. 14).]

7. At an auction sale, *A* makes the highest bid for a flower vase. Purporting to accept the bid the auctioneer strikes the hammer, but strikes the vase and breaks it. Who is to bear the loss? Would your decision differ if the auctioneer had struck

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the table, on which the vase was kept, with the hammer and the vase fell down and broke into pieces?

[**Hint.** The loss in both the cases is to be borne by the owner of the flower vase, because at the time of the completion of the contract, namely, striking the hammer, the goods forming the subject matter of the contract have perished, and as such impossibility of performance at the time of contract renders the agreement *void ab-initio.*]

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PART III

Law of Partnership

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Chapter 21

Definition and Nature of Partnership

The law of partnership is contained in the Indian Partnership Act, 1932,[1] which came into force on 1st October 1932, except Section 69 (dealing with the effect of non-registration of firms), which came into force on 1st October 1933. Since partnership comes into existence only by a contract between the parties for the purpose, the provisions of the Indian Contract Act, except when they are inconsistent with the express provisions of the Partnership Act, continue to apply to partnership firms (Sec. 3).

Definition of Partnership

Section 4 of the Indian Partnership Act, 1932, defines 'partnership' in the following terms:

"Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

Essential elements. This definition contains five elements which constitute a partnership, namely: (1) There must be a contract; (2) between two or more persons; (3) who agree to carry on a business; (4) with the object of sharing profits; and (5) the business must be carried on by all or any of them acting for all (*i.e.*, there must be mutual agency).

All the above elements must coexist in order to constitute a partnership. If any of these is not present, there cannot be a partnership. We now discuss these elements one by one:

1. **Contract.** Partnership is the result of a contract. It does not arise from status, operation of law or inheritance. Thus at the death of father, who was a partner in a firm, the son can claim share in the partnership property but cannot become a partner unless he enters into a contract for the same with other persons concerned. Similarly, the members of Joint

[1]Throughout part III of this book (*i..e.*, Chapters 21-24), which deals with the Law of Partnership, the references to Sections, unless otherwise specifically stated, are references to Sections of the Indian Partnership Act, 1932. The word 'Act' wherever used means the Indian Partnership Act, 1932.

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Hindu Family carrying on a family business cannot be called partners for their relation arises not from any contract but from status. To emphasise the element of contract, Sec. 5 expressly provides that "the relation of partnership arises from contract and not from status."

Thus a 'contract' is the very foundation of partnership. It may, however, be either express of implied. Again, it may be oral or in writing (*Laxmibai* vs *Roshan Lal*[2]).

2. Association of two or more persons. Since partnership is the result of a contract, at least two persons are necessary to constitute a partnership. The Partnership Act does not mention any thing about the maximum number of persons who can be partners in a partnership firm but Sec. 11 of the Companies Act, 1956, lays down that a partnership consisting of more than 10 persons for banking business and 20 persons for any other business would be illegal. Hence these should be regarded as the maximum limits to the number of partners in a partnership firm.

Only persons competent to contract can enter into a contract of partnership. Persons may be natural or artificial. A company may, being an artificial legal person, enter into a contract of partnership, if authorised by its Memorandum of Association to do so. Even there could be a partnership between a number of companies (*Steel Bros. & Co Ltd.* vs *Commissioner of Income-tax*[3]). A partnership firm, since it is not recognised as a legal person having a separate entity from that of partners, cannot enter into contract of partnership with another firm or individuals (*Duli Chand* vs *Commissioner of Income-tax*[4]). When a firm (under a firm name) enters into a contract of partnership with another firm or individual, in that case, in the eye of law the members of the firms or firm become partners in their individual capacity (*Commissioner of Income-tax* vs *Jadavji Narsidas & Co.*[5]).

3. Carrying on of business. The third essential element of a partnership is that the parties must have agreed *to carry on a business.* The term 'business' is used in its widest sense and includes every trade, occupation or profession [Sec. 2(*b*)]. If the purpose is to carry on some charitable work, it will not be a partnership. Similarly, if a number of persons agree to share the income of a certain property or to divide the goods purchased in bulk amongst themselves, there is no partnership and such persons cannot be called partners because in neither case they are carrying on a business. Thus, where *A* and *B* jointly purchased a tea shop and incurred additional expenses for purchasing pottery and utensils for the job, contributing the

[2]A.I.R. (1972), Raj. 288.
[3]A.I.R. (1958), S.C. 315.
[4]A.I.R. (1956), S.C. 354.
[5]A.I.R. (1963), S.C. 1467.

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necessary money half and half and then leased out the shop on rent which was shared equally by them, it was held that they are only co-owners and not partners as they never carried on any business (*Govind Nair* vs *Maga*[6]).

Further, in order to be a partnership, the business must be 'carried on' which suggests continuity or repetition of acts. Merely a single isolated transaction of purchase and sale by a number of persons does not mean carrying on of the business. But if a number of articles are purchased at one time and the sales are to go on, profits are to be realised and are to be divided amongst a number of persons, there is a carrying on of business. Section 8, however, provides that there can be 'particular partnership' between partners whereby they engage in a particular adventure or undertaking, which if successful, would result in profit. Thus, there can be a partnership business as to the working out of a coal mine, or the sowing, cropping, harvesting and sale of a particular crop, or the production of a film because although in each of these cases there is a single adventure but the same requires a series of transactions and continuing relationship (*Ram Dass* vs *Mukut Dhari*[7]). It may also be noted that an agreement to carry on business at a future time does not result in partnership unless that time arrives and the business is commenced (*R.R. Sarna* vs *Reuben*[8]).

4. **Sharing of profits.** This essential element provides that the agreement to carry on business must be with the object of sharing profits amongst all the partners. Impliedly the partnership must aim to make profits because then only profits may be divided amongst the partners. Thus, there would be no partnership where the business is carried on with a philanthropic motive and not for making a profit or where only one of the partners is entitled to the whole of the profits of the business. The partners may, however, agree to share profits in any ratio they like.

Sharing of losses not necessary. To constitute a partnership it is not essential that the partners should agree to share the losses (*Raghunandan* vs *Harmasjee*[9]). It is open to one or more partners to agree to bear all the losses of the business. The Act, therefore, does not seek to make agreement to share losses a test of the existence of partnership. Section 13(*b*), however, provides that the partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm, unless otherwise agreed. Thus sharing of losses may be regarded as consequential upon the sharing of profits and where nothing is said as to the sharing of losses, an agreement to share profits implies an agreement to share losses as well. It must be noted that even though a partner may not

[6](1948), 1 Mad. 343.
[7]A.I.R. (1952), V.P. 1.
[8]A.I.R. (1946), Oudh 68.
[9]A.I.R. (1927), Bom. 187.

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share in the losses of the business, yet his liability *vis-a-vis* outsiders shall be unlimited because there cannot be 'limited partnerships' in our country under the Partnership Act.

Sharing of profits not conclusive test. Although sharing of profits is an evidence of partnership but this is not the conclusive test of partnership. There may be persons sharing the profits of a business but who do not by that reason become partners. In this respect Explanation II to Section 6 clearly states: "The receipt by a person of a share of the profits of a business, or of a payment contingent upon the earning of profits or varying with the profits earned by a business, does not of itself make him a partner with the persons carrying on the business; and, in particular, the receipt of such share or payment:

(a) by a lender of money to persons engaged or about to engage in any business,

(b) by a servant or agent as remuneration,

(c) by a widow or child of a deceased partner as annuity, or

(d) by a previous owner or part-owner of the business as consideration for the sale of the goodwill or share thereof, does not itself make the receiver a partner, with the persons carrying on the business." The question whether a person sharing profits of a business is a partner or not depends upon the real relation between the parties, as shown by all relevant facts taken together (Sec.6).

5. **Mutual agency.** The fifth element in the definition of a partnership provides that the business must be carried on by all the partners or any (one or more) of them acting for all, that is, there must be mutual agency. Thus every partner is both an agent and principal for himself and other partners, *i.e.* he can bind by his acts the other partners and can be bound by the acts of other partners in the ordinary course of business. To test whether a person is a partner or not, it should be seen, among other things, whether or not the element of agency exists, *i.e.*, whether the business is conducted on his behalf. It is on the basis of this test that a widow of a deceased partner or a manager having a share in the profits is not a partner, because business is not carried on, on her or his behalf. If she or he does something the firm is not legally bound by that.

The importance of the element of mutual agency lies in the fact that it enables every partner to carry on the business on behalf of others. Partners may agree among themselves that some one of them shall not enter into any contracts on behalf of the firm, but by virtue of the principle of mutual agency, such partner can bind the firm *vis-a-vis* third parties without notice in contracts made according to the ordinary usage of trade. Of course he can be made liable by other partners *inter-se* for exceeding his authority. In fact, the law of partnership governing relations of the partners *inter-se*

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and with the outside world is an extension of the law of agency. In *Cox* vs *Hickman*[10] it was rightly observed: "The law as to partnership is undoubtedly a branch of the law of the principal and agent.... The liability of one partner for the acts of his co-partner is in truth the liability of a principal for the acts of his agent. Where two or more persons are engaged as partners in an ordinary trade, each of them has an implied authority from the others to bind all by contracts entered into according to usual course of business in that trade. Every partner in trade is, for the ordinary purposes of the trade, the agent of his co-partners; all are therefore liable for the ordinary trade contract of the other. The public have a right to assume that every partner has authority from his co-partners to bind the whole firm in contracts made according to the ordinary usage of trade."

Test of Partnership

As must be clear from the above discussion of various elements of partnership, there is no single test of partnership. For example, in one case there may be sharing of profits but may not be any business, in the other case there may be business but there may not be sharing of profits, in yet another case there may be both business and sharing of profits but the relationship between persons sharing the profits may not be that of principal and agent. And in either case, therefore, there is no partnership. Thus, all the essential elements mentioned before must co-exist in order to constitute a partnership. To emphasise this fact Sections 6 expressly provides that "in determining whether a group of persons is or is not a firm or whether a person is or is not a partner in a firm, regard shall be had to the real relation between the parties, as shown by all relevant facts taken together." Thus, the existence of partnership has to be determined with reference to the real intention of the parties, which must be gathered from all the facts of the case and the surrounding circumstances.

Partners, Firm and Firm Name

Persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm' and the name under which their business is carried on is called the 'firm name' (Sec. 4).

A 'firm' is not a separate legal entity distinct from its members. It is merely a collective name of the individuals composing it. Hence, unlike a company which is a separate legal entity distinct from its members, a firm cannot possess property or employ servants, neither it can be a debtor nor a creditor. It cannot sue or be sued by others. It is only for the sake of convenience that in commercial usage terms like 'firm's property,'

[10](1860), 8 H.L.C. 268.

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'employee of the firm,' 'suit against the firm' and so on are used, but in the eye of law that simply means 'property of the partners,' 'employee of the partners' and 'a suit against the partners' of that firm. It is relevant to state that for the purposes of the Income Tax Act, a partnership firm is an entity quite distinct from the partners composing it and is assessable separately.

The partners are free to choose any name for the firm subject to the following rules:

1. The name must not be too identical or similar to the name of another existing firm doing similar business so as to lead to confusion (*Havana Cigars Factories Ltd.* vs *Oddenino*[11]). The reason for this rule being that the reputation or goodwill of a firm may be injured, if a new firm could adopt an allied name.

2. The name must not contain words like Crown, Emperor, Empress, Empire, Imperial, King, Queen, Royal, or words expressing or implying the sanction, approval or patronage of Government except when the State Government signifies its consent to the use of such words as part of the firm name by order in writing [Sec. 58(3)].

Distinction between Partnership and Co-ownership

Explanation I to Sec. 6 lays down that "the sharing of profits or of gross returns arising from property by persons holding a joint or common interest in that property does not of itself make such persons partners." Thus, the mere fact that two or more persons own some property jointly does not mean that there exists a partnership. The sons of a father who inherit some property are not partners, even though the property were to be managed jointly and the income from it were to be shared.

A partnership can come into existence only when there is an agreement among persons (or co-owners) to carry on a business with a view to share the profits thereof. If the above mentioned sons of a father enter into an agreement to run a coffee house and share the income thereof, they become partners immediately on starting the coffee house.

According to Lord Lindley the main points of difference between co-ownership and partnership are as follows:[12]

1. "Co-ownership is not necessarily the result of agreement. Partnership is.

2. Co-ownership does not necessarily involve community of profit or of loss. Partnership does.

3. One co-owner can, without the consent of the others, transfer his interest to a stranger, so as to put him in the same position as regards other

[11](1924), 1 Ch. 179.

[12]See *Lindley's Law of Partnership*, pp. 57-58.

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owners as the transferor himself was before the transfer. A partner cannot do this.

4. One co-owner is not as such the agent real or implied of the other. A partner is.

5. One co-owner has no lien on the thing owned in common for outlays or expenses, nor for what may be due from the others as their share of a common debt. A partner has.

6. Co-ownership not necessarily existing for the sake of gain, and partnership existing for no other purpose, the remedies by way of account and otherwise which one co-owner has against the others are in many important respects different from, and less extensive than those which one partner has against his co-partners."

Besides the above differences, a few more points of distinction between the two are also worth nothing. These are:

1. In co-ownership there is no maximum limit of co-owners. In a partnership the maximum limit of partners has been fixed at 10 in a banking business and 20 in any other type of business.

2. Co-ownership does not necessarily involve the carrying on of a business but a partnership does.

3. A co-owner is entitled to demand partition of joint property *in specie*. A partner has no such right and he can only sue his co-partners for the dissolution of the firm and accounts.

Distinction between Partnership and Joint Hindu Family Business

Section 5 lays down that "the relation of partnership arises from contract and not from status; and, in particular, the members of a Hindu undivided family carrying on a family business as such are not partners in such business." Thus if two or more members of a Joint Hindu Family carry on a business inherited from their ancestors, it is not a partnership because it has been created by status or obtained by birth and not by an agreement. But there is nothing to prevent the members of a Joint Hindu Family from entering into a partnership agreement between themselves. It may be mentioned that the expression 'family business' is not confined to ancestral family business and a new business started by the 'Karta'[13] or by the members of Joint Hindu Family with the aid of ancestral or joint family funds will also fall within the scope of the 'family business.'

A Hindu undivided family is not a separate legal entity distinct from its members, hence it cannot enter into a contract of partnership with another individual. It is only the 'Karta' of a Joint Hindu Family (as representing the family) who can enter into a partnership agreement with

[13]The manager of a Joint Hindu Family is called its *Karta*.

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another person and become a partner in the firm. Of course within the meaning of Income-Tax Act a Hindu undivided family is an entity distinct from the members composing it and is assessable separately.

The main points of distinction between a partnership and joint Hindu family business are as follows:

1. **Regulating law.** A partnership is governed by the provisions of the Indian Partnership Act, 1932. A joint Hindu family business is governed by the principles of Hindu law.

2. **Mode of creation**. A partnership arises out of a contract, whereas a joint Hindu family business arises by the operation of law and is not the result of a contract.

3. **Admission of new members.** In a partnership no new partner is admitted without the consent of all the partners, while in the case of a joint Hindu family firm a new member is admitted just by birth.

4. **The position of females.** In a partnership women can be full-fledged partners, while in a joint Hindu family business membership is restricted to male members only. After the passage of the Hindu Succession Act, 1956, females get only co-sharer's interest at the death of a coparcener and they do not become coparceners themselves.

5. **Number of members.** In partnership the maximum limit of partners is 10 for banking business and 20 for any other business but there is no such maximum limit of members in the case of joint Hindu family business.

6. **Authority of members.** In partnership each partner has an implied authority to bind his co-partners by act done in the ordinary course of the business, there being mutual agency between various partners. In a joint family business all the powers are vested in the 'Karta' and he is the only representative of the family who can contract debts or bind his coparceners by acts done in the ordinary course of business, there being no mutual agency between various coparceners. But a coparcener other than the Karta of the family may be authorised expressly or by implication to contract debts on behalf of the firm (*Lal Chand* vs *Ghanayalal*[14]).

7. **Liability of members.** In partnership, the liability of the partners is joint and several as well as unlimited. In other words, each partner is personally and jointly liable to an unlimited extent and if partnership liabilities cannot be fully discharged out of the partnership property each partner's separate personal property is liable for the debts of the firm. In a joint Hindu family business only the Karta is personally liable to an unlimited extent, *i.e.*, his self-acquired or other separate property besides his share in the joint family property is liable, for debts contracted on behalf of the family business. Other coparceners' liability is limited to the extent of their interest in the joint family property and they do not incur any

[14](1939), Lah. 243.

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personal liability. But an adult coparcener can be made personally liable if he is also,' expressly or impliedly, a party to the contract or if he has subsequently ratified and accepted the transaction out of which the obligation of the creditor arose (*Lal Chand* vs *Ghanayalal*[15]).

8. **Right of members to share in profits.** In a partnership each partner is entitled to claim his separate share of profits but a member of a joint Hindu family business has no such right. His only remedy lies in a suit for partition.

9. **Effect of death of a member.** A partnership, subject to contract between the partners, is dissolved on the death of a partner, but a joint Hindu family firm is not dissolved on the death of a coparcener (*Baij Nath* vs *Ram Gopal*[16]).

Distinction between Partnership and Company

The main points of difference between a joint stock company and a partnership firm are as follows:

1. **Regulating Act.** A partnership firm is governed by the provisions of the Indian partnership Act, 1932, whereas a company is governed by the provisions of the Companies Act, 1956.

2. **Number of Members.** The maximum number of members in the case of a firm is fixed at 10 for banking business and at 20 for any other business, but no such maximum limit is fixed in the case of a public company. The maximum number of members of a private company, however, must not exceed 50 excluding members who are or were in the employment of the company. The minimum number of members in a public company is seven and in case of a private company two. In case of a partnership the minimum number of partners is two.

3. **Entity.** A partnership firm has no separate legal entity distinct from the members composing it. A company, on the other hand, is a separate legal entity different from its members.

4. **Liability.** In partnership, each partner has unlimited liability and is personally liable for all the debts of the firm. In a company, on the other hand, a shareholder has limited liability—limited to the extent of the unpaid amount on the shares held by him or the amount guaranteed by him to be his contribution in case the company is wound up—unless it is an unlimited company which is an exception.

5. **Authority of members.** In partnership each partner has an implied authority to bind his co-partners by acts done within the ordinary course of business, but in a company a shareholder has no such authority, there being

[15] *Ibid.*
[16] A.I.R. (1939), Cal. 92.

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no mutual agency between various shareholders.

6. **Management.** All the partners of a firm are entitled to take part in the management of the business; but in the case of a company the right to control and manage the business is vested in the Board of Directors elected by the shareholders.

7. **Transfer of interest.** A partner cannot transfer his interest in the firm without the consent of all other partners. He may, of course, assign his share in the partnership but the assignee merely becomes entitled to the financial benefits in respect of the share and does not become a partner unless the other members of the firm agree. In case of a private company also the transfer of shares requires the prior permission of the Board of Directors. But in the case of a public company a shareholder can transfer his shares freely without restriction and the transferee succeeds to all the rights of membership.

8. **Audit.** The audit of the accounts of a company is a legal necessity but it is not so in the case of a partnership carrying on business if the annual total sales, turnover or gross receipts in business do not exceed Rs 40 lakhs.[17]

9. **Registration.** A partnership firm may or may not be registered but in the case of a company registration is essential.

10. **Winding up.** A partnership firm can be wound up at any time by any partner, if it is 'at will', without legal formalities. In the case of a company, no one member can require it to be wound up at will and winding up involves legal formalities.

TEST QUESTIONS

1. Define partnership. What are the essential elements of a partnership?
2. "Although sharing of profits is an essential element of partnership, it is not the sole test." Comment.
3. What tests would you apply for determining the existence of partnership?
4. Distinguish partnership from *(i)* co-ownership, *(ii)* Joint Hindu Family business, and *(iii)* joint stock company.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* and *B*, two chartered accountants, agree to carry on practice in common at the office of *A* under the name "*A* and *B*" for a period of seven years. The terms of agreement entered into between them provide that *B* should manage the office and supervise the clerical work and that he should draw a fixed allowance of Rs 2,000 per month in lieu of profits. It is further agreed that losses, if any, shall be

[17]The Finance Act, 1984.

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borne by *A* alone, and that after seven years *A* would be entitled to the office and all the other equipments, and *B* would not have any right, or claim, in respect of them. Are *A* and *B* partners?

[**Hint**. Yes, *A* and *B* are partners. In a partnership, partners are free to agree to any terms as regards sharing of profits. Again, sharing of losses is not necessary for becoming a partner. So also, partners may agree that on the dissolution of their partnership all the assets will belong to one partner only.]

2. *A* is the sole proprietor of a firm. He admits *B* as a partner on the following terms: *(i) B* is not to bring any capital, *(ii) B* is not to be responsible for any loss, *(iii) B* is to receive Rs 10,000 per annum in lieu of profits, *(iv) B* is not to enter any contracts on behalf of the firm. Discuss the legal position of *B*.

[**Hint**. *B* is a partner with *A* because to constitute a partnership neither contribution of capital nor active participation in management of the business is essential.]

3. *M*, a clerk in *K*'s business, entered into a verbal agreement with *K* for a share of profit and loss in the proportion of one-sixth to *M* and five-sixth to *K*. It was further agreed that the building in which the business was carried on should remain the property of *K*. *M* alleges that he is a partner and claims dissolution of the firm and an account of assets. *K* denies the partnership, and alleges that *M* is only a clerk. Decide.

[**Hint**. In view of the surrounding circumstances of the case it is evident that *M* is only a clerk. It is an established fact that sharing of profits is not the sole test of partnership.]

4. *A* and *B*, two Kartas of two joint Hindu families consisting of *M,N, O* and *P,Q,R* as the members of the two families respectively, enter into a partnership for the benefit of their respective families and contribute from the family funds towards the capital of the partnership. Are *M, N, O, P, Q* and *R* partners?

[**Hint**. No, *M, N, O, P, Q* and *R* are not partners. In the eye of law it is a partnership between *A* and *B*, the two Kartas, each Karta being counted as one person, and the other members of the two families do not *ipso facto* become partners.]

5. *P, Q, R, S,* and *T,* all adult members of a joint Hindu family convert their family business into partnership. Is the partnership valid?

[**Hint**. Yes, the partnership is valid. The law permits the members of a joint Hindu family to convert their family business into a contractual partnership.]

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Chapter 22

Formation of Partnership

In the preceding chapter we have observed that a partnership may be formed by oral or by written agreement or an agreement of partnership can be inferred from the conduct of the parties. The following basic facts must be borne in mind by the persons desirous of entering into an agreement of partnership:

1. The successful working of a partnership depends upon mutual confidence and utmost good faith among the partners because each partner is an agent of others and binds them to the fullest extent of their fortunes. It is, therefore, necessary that the partners of a firm be selected with extreme care and caution. There goes a saying: "Do not be in too great a hurry while selecting a partner. Choosing a partner is like choosing a wife, marry in haste and repent at leisure."

2. All the essential elements of a valid contract must be present. There must be free consent of the parties who must be competent to contract and the object of the partnership should not be forbidden by law or immoral or opposed to public policy.

3. The mutual rights and obligations of partners must be discussed in detail and should be put in black and white in the shape of a "partnership deed," before the partnership is actually started. An oral agreement may be alright till the going is normal but in times of adversity or windfall gains, there may be dispute among the partners, on sharing the losses or profits respectively. In such circumstances an oral agreement is futile as on its basis it is difficult to prove that such and such conditions were agreed upon. It is, therefore, best to have a written agreement.

4. The partnership should be registered as soon as it is formed with the Registrar of Firms of the area. In the absence of registration, the firm will not be able to enforce its legal remedies against outsiders.

Partnership Deed

The document in which the respective rights and obligations of the members of a partnership are set forth is called a 'partnership deed.' It should be drafted with care and be signed by all the partners. It must

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stamped in accordance with the Indian Stamp Act. Each partner should have a copy of the Deed. The firm should be registered and a copy of the Deed should be filed at the time of registration with the Registrar of Firms because in the absence of such registration partners cannot enforce the conditions laid down in the Deed through a court of law.

The Deed should cover the following points:

(i) The name of the firm and the names and addresses of partners who compose it.

(ii) Nature of business and the town and place where it will be carried on.

(iii) Date of commencement of partnership.

(iv) The duration of partnership.

(v) The amount of capital to be contributed by each partner and the methods of raising finance in future if so required.

(vi) The ratio of sharing profits and losses.

(vii) Interest on partners' capital, partners' loan, and interest, if any, to be charged on drawings.

(viii) salaries, commissions *etc.*, if any, payable to partners.

(ix) The method of preparing accounts and arrangement for audit and safe custody of cash *etc.*

(x) Division of task and responsibility, *i.e.*, the duties, powers and obligations of all the partners.

(xi) Rules to be followed in case of retirement, death and admission of a partner.

(xii) Expulsion of partners in case of gross breach of duty or fraud.

(xiii) Can a partner carry on a competing business or any other business whether competing or not. Section 11(2) clearly provides that the Deed may provide that a partner shall not carry on any business other than that of the firm while he is a partner, notwithstanding anything contained in Section 27 of the Indian Contract Act where agreements in restraint of trade are void.

(xiv) The circumstances under which the partnership will stand dissolved.

(xv) Arbitration in case of dispute among the partners.

The terms laid down in the Deed may be varied by consent of all the partners, and such consent may be expressed or may be implied by a course of dealing [Sec. 11(1)].

Duration of Partnership

From the duration point of view the partnerships may be classified into the following two categories:

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1. **Partnership at will.** Where no provision is made by contract between the partners for the duration of their partnership or for the determination of their partnership, the partnership is 'partnership at will' (Sec. 7). Thus, the essence of a 'partnership at will' is that the partners do not fix any term of partnership and are free to break their relationship at their sweet will. It is a partnership for an indefinite period. Such a partnership may be dissolved by any partner by giving a notice to that effect to all the other partners [Sec. 43(1)]. It may be noted that if this freedom to dissolve the firm at will is curtailed by agreement, say, if the agreement provides that the partnership can be dissolved by mutual consent of all the partners only, it will not constitute a 'partnership at will.'

2. **Particular partnership.** When a partnership is formed for a *particular period or for a specific venture, e.g.,* for working a coal mine or producing a film, it is called a 'particular partnership' (Sec. 8). In such a case the partnership is automatically dissolved at the expiry of the fixed term or on the completion of the venture (Sec. 42). Before such time the partnership would not be dissolved unless all the partners agree to it (Sec. 40). If the partners decide to continue such a partnership even after the expiry of the fixed term or the completion of the specific venture then it becomes a 'partnership at will.'

Kinds of Partners

There may be various types of partners in a partnership firm which are as follows:

1. **Active or actual partners.** Partners who take an active part in the conduct of the partnership business are called 'actual' or 'ostensible' partners. They are full-fledged partners in the real sense of the term. Such a partner must give public notice of his retirement from the firm in order to free himself from liability for acts after retirement.

2. **Sleeping or dormant partners.** Sometimes, however, there are persons who merely put in their capital (or even without capital they may become partners) and do not take active part in the conduct of the partnership business. They are known as 'sleeping' or 'dormant' partners. They do share profits and losses (usually less than proportionately), have a voice in management, but their relationship with the firm is not disclosed to the general public. They are liable to the third parties for all acts of the firm just like an undisclosed principal. They are, however, not required to give public notice of their retirement from the firm.

3. **Silent partners.** Those who by agreement with other partners have no voice in the management of the partnership business are called 'silent' partners. They share profits and losses, are fully liable for the debts of the firm and may take active part in the conduct of the business.

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4. **Partner in profits only.** A partner who has stipulated with other partners that he will be entitled to a certain share of profits, without being liable for the losses, is known as a 'partner in profits only.' As a rule such a partner has no voice in the management of the business. However, his liability *vis-a-vis* third parties will be unlimited because in India we cannot have 'limited partnership'.

5. **Sub-partner.** When a partner agrees to share his share of profits in a partnership firm with an outsider, such an outsider is called a sub-partner. Such a sub-partner has no rights against the firm nor he is liable for the debts of the firm.

6. **Partner by estoppel or holding out** (Sec. 28). If a person represents to the outside world by words spoken or written *or* by his conduct *or* by lending his name, that he is a partner in a certain partnership firm, he is then estopped from denying his being a partner, and is liable as a partner in that firm to any one who has on the faith of such representation granted credit to the firm. Actually such a person is not a partner in that firm—no agreement, no sharing in profits and losses, no say in the management, may not be knowing exact place of business, but as he holds himself out to be a partner, he becomes responsible to outsiders as a partner on the principle of *estoppel or holding out*. It is for this reason that such a person is called as 'partner by estoppel' or 'partner by holding out.' He may also be called as 'quasi partner' for he is not a partner in the full implications of the term; only in the eyes of outside world he is considered a partner. He may also be known as 'nominal partner.'

It is to be emphasised that in order to entitle a person to bring an action under the doctrine of holding out it must be shown that he acted on the faith of the representation while giving credit to the firm. It does not matter whether the person representing himself or represented to be a partner does or does not know that the representation has reached the other person so giving credit. But a person who knows nothing about the representation or who knows but does not believe it or who knows about it subsequently cannot take advantage of this doctrine and make the supposed partner liable as a partner (*Juggilal Kamalapat* vs *Shiv Chand Bagree*[1]).

ILLUSTRATIONS. *(a)* *P* represents to *R* that he is a partner in the firm of *X, Y* and *Z*, while actually he is not a partner. On the faith of this representation *R* gives credit to the firm. The firm of *X, Y* and *Z* becomes insolvent. *R* can make *P* liable on the basis of holding out and *P* is estopped from denying that he is a partner in the firm.

(b) *A, B* and *C* are partners in a firm. *D*, who is generally seen in the company of *A, B* and *C*, tells *M* that he is also a partner in the firm. *P*, who overhears this

[1]A.I.R. (1960), Cal. 463.

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talk of *D* to *M* and thinking *D* to be a partner of the firm, gives credit to the firm. *P* can make *D* liable for the credit given to the firm on the basis of holding out because for taking advantage of the doctrine of holding out it is not necessary that the representation must be made directly to the person so giving credit.

(c) X, who is not a partner in the firm consisting of *Y* and *Z*, represents to *A* that he is also a partner in the firm. *B*, who does not know of the representation gives credit to the firm of *Y* and *Z*. *B* cannot make *X* liable for the credit given to the firm on the basis of holding out because he has not actually acted on the faith of the representation while giving credit to the firm.

(d) A partnership firm consists of *A, B, C* and *D*. *D* retires from the firm, but fails to give public notice of his retirement and his name continues to be used on letter heads. *D* is liable as a partner by holding out to creditors who have lent on the faith of his being a partner.

It must be noted that the doctrine of holding out does not extend to make the estate or legal representatives of a deceased partner liable for the acts of the firm done after the death of the partner even though no public notice of partner's death is given and the business is continued in the old firm name [Sec. 28(2)]. The principle of holding out does not apply in the case of insolvent partner also (Sec. 45).

Minor Admitted to the Benefits of Partnership

Partnership is based on mutual contract and, therefore, only those who possess the capacity to contract can be partners in a partnership firm. According to the Indian Contract Act an agreement by a minor is void *ab-initio* as against him but he can derive benefit under it. As such a minor cannot be a full-fledged partner, he can atmost be admitted to the benefits of a partnership. Section 30 of the Partnership Act thus provides that though a minor cannot be a partner in a firm, but, with the consent of all the partners for the time being, he may be admitted to the benefits of partnership by an agreement executed through his guardian with the other partners. The following points must be noted in this connection:

(i) A minor can be admitted to the benefits of a partnership with the consent of all the existing partners. Consent only of the majority of partners would not be sufficient.

(ii) There must be a partnership in existence before a minor can be admitted to its benefits.

(iii) There cannot be a partnership consisting of all minors (*Shriram Didwani* vs *Gourishanker*[2]).

(iv) If a minor is made a full-fledged partner under the terms of a partnership deed, the deed would be invalid not only *vis-a-vis* the minor but also in regard to other partners. Since a minor cannot enter into any contract

[2]A.I.R. (1961), Bom. 136.

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of partnership, the deed representing the contract is void *ab-initio* in toto and cannot be enforced even *vis-a-vis* the remaining adult partners (*Dharam Vir* vs *Jagan Nath*[3]).

The rights and liabilities of a minor who has been admitted to the benefits of partnership are governed by the following rules[4]:

1. The minor is entitled to receive his agreed share of the property and of the profits of the firm.

2. The minor has the right of inspecting and taking copies of the books of accounts of the firm. He has, however, no such right in respect of books other than accounts, as they may contain secrets which should be restricted to real partners alone.

3. The minor is not personally liable to *third parties* for the debts of the firm, but his liability is limited only upto his share in the partnership assets and profits. If partnership assets fall short in extinguishing the debts of the firm the separate personal property of the minor cannot be applied for payment of the firm debts. To put it differently, the minor shall be a partner in profits only and shall not share in the losses except when liability to third party has arisen but then too upto his share in the profits and property of the firm.

4. The minor is not entitled to take part in the conducting of the business as he has no representative capacity to bind the firm.

5. The minor cannot bring about any suit against the partners for an account or payment of his share of the property or profits of the firm except when he severs his connection with the firm.

6. On attaining majority or on knowing that he had been admitted to the benefits of partnership, whichever date be later, the minor must decide within six months whether he would or would not like to become a partner in the firm and give public notice of his decision. If he remains silent and fails to give such a notice, it will be presumed that he has elected to be a partner in the firm.

The burden of proving the fact that the minor had no knowledge of his being a partner until a particular date after the expiry of six months of his attaining majority lies on the person asserting that fact.

7. Where the minor becomes a partner either by his own election or by his failure to give notice within the specified time, he becomes personally liable to the third parties for all the debts and obligations of the firm retrospectively from the date of his admission to the benefits of partnership. Of course, his share in the property and profits of the firm shall be the same to which he was entitled as a minor.

[3]A.I.R. (1968), Punj. 84.
[4]Section 30.

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8. Where the minor chooses not to become a partner:

(a) his rights and liabilities continue to be those of a minor up to the date of his giving public notice;

(b) his share is not liable for any acts of the firm done after the date of the public notice;

(c) he is entitled to sue the partners for his share of the property and profits in the firm.

9. If after attaining majority but before choosing to become a partner the minor represents or knowingly permits himself to be represented as a partner in the firm, he will be personally liable to any one who has on the faith of such representation granted credit to the firm on the ground of 'holding out'.

Registration of Firms

Prior to the passing of the Indian Partnership Act, 1932, there was no provision for the registration of partnership firms in India. As a result it was difficult for a third person to prove the existence of partnership and make his claim against all the members of the firm. Whenever the question of partners' liability arose, they did not hesitate to deny their membership of the partnership in question. As such there was a demand for compulsory registration, as prevalent in England, so that necessary particulars regarding the constitution of the firm could be made available to those who may be dealing with the firm.

In view of the very large number of small partnership firms working in India, where registration may not produce much public benefit, the present Act has made the registration *optional* entirely at the discretion of partners. Under the Partnership Act it is *not compulsory* for every partnership firm to get itself registered, but an unregistered firm suffers from a number of disabilities. In practice, therefore, few partnerships would deem it advisable to remain unregistered.

Time of registration. Registration may take place *at any time* during the continuance of the partnership firm. Where the firm intends to institute a suit in a court of law to enforce rights arising from any contract, registration must be effected before the suit is instituted otherwise the court shall not entertain the suit. Registration may also be effected even after a suit has been filed by the firm but in that case it is necessary to withdraw the suit, get the firm registered and then file a fresh suit. Registration of the firm subsequent to the institution of the suit cannot by itself cure the defect.

Procedure of registration (Sec. 58). The procedure of registration is very simple. An application in the prescribed form along with the prescribed fee has to be submitted to the Registrar of Firms of the State in which any place of business of the firm is situated or proposed to be

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situated. The application or statement must be signed by all the partners, or by their agents specially authorised in this behalf, and must contain the following particulars:

1. The name of the firm.
2. The place or principal place of business of the firm.
3. The names of any other places where the firm carries on business.
4. The date when each partner joined the firm.
5. The names in full and permanent addresses of the partners.
6. The duration of the firm.

When the Registrar is satisfied that the above provisions have been duly complied with, he shall record an entry of the statement in a register called the Register of Firms, and shall file the statement (Sec. 59). This completes the procedure of registration.

Change of particulars. With a view to keep the Registrar of Firms posted with up-to-date information regarding the firm, if any change takes place in any of the particulars given above, it should be notified to the Registrar, who shall thereupon incorporate the necessary change in the Register of Firms. Further, the Registrar should also be informed when any partner ceases to be a partner by retirement, expulsion, insolvency or death, or when a new partner is admitted or a minor, having been admitted, elects to become or not to become a partner, or when the firm is dissolved. (Secs. 60-63)

Penalty for false particulars (Sec. 70). If any person knowingly or without belief in its truth signs any statement, amending statement, notice or intimation containing false or incomplete information to be supplied to the Registrar, he shall be punishable with imprisonment which may extend to three months, or with fine, or with both.

Effects of Non-registration (Sec. 69)

An unregistered firm and its partners suffer from the following disabilities:

1. **No suit in a civil court by a partner against the firm or other copartners.** If any dispute arises among the partners or between a partner and the firm or between a partner and ex-partners, and the dispute is based upon the rights arising from contract (*i.e.*, partnership deed) or upon the rights conferred by the Partnership Act, then a partner of an unregistered firm cannot institute a suit to settle such disputes. However, criminal proceedings can be brought by one partner against the other(s). Thus, if a partner steals the property of the firm or puts fire to the buildings of the firm, any partner can prosecute him for the same.

2. **No suit in a civil court by firm against third parties.** An unregistered firm cannot file a suit against a third party, if it so becomes nec-

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essary, to enforce any right arising from contract, *e.g.*, for the recovery of the price of goods supplied. Of course, criminal proceedings can be brought against the wrong doers. It may be noted that a suit by a third party against the firm or its partners is not prohibited, it is only a suit by the firm, and that too arising out of a contract, against a third party which is prohibited.

3. **The firm or its partners cannot make a claim of set-off or other proceeding based upon a contract.** The above two disabilities also apply to a claim of *set-off* or *other proceeding* to enforce a right arising from a contract. Thus, if a third party sues the firm to recover a sum of money, the firm cannot claim a set-off, *i.e.*, the firm cannot say that the third party also owes some money to the firm and the same should be adjusted against the claim in question. Similarly, if an unregistered firm institutes a suit for the reduction of rent against its landlord, such a suit is not maintainable because the suit falls under the disability relating to "other proceeding" to enforce a right arising from a contract (*Gappulal Gordhandas* vs *Chunilal Shyamlal*[5]).

Exceptions. Non-registration of a firm does not, however, affect the following rights, namely:

1. The right of third parties to sue the firm or any partner.
2. The right of partners to sue for the dissolution of the firm or for the accounts of a dissolved firm or for the realisation of the property of a dissolved firm (*i.e.*, for claiming share of the assets of a dissolved firm or for recovering money from firm's debtors).
3. The power of an Official Assignee or Receiver or the Court, as the case may be, to realise the property of an insolvent partner and to bring an action therefore, if necessary, on behalf of the insolvent.
4. The rights of firm or partners of firm having no place of business in India.
5. The right to sue or claim a set-off if the value of suit does not exceed Rs100 in value.

It may be mentioned that registration of firms from Income-tax point of view is different from the registration of firms discussed above. For the purpose of assessment of Income-tax separate registration with the Income-tax department is needed. However, this is also optional.

Register of Firms

The Register of Firms maintained at the Registrar of Firms' office contains complete and up-to-date information about each registered firm regarding all matters likely to affect the interests of those persons who propose to deal with the firm. The Registrar is empowered to rectify any

[5]A.I.R. (1961), Raj. 286.

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mistake in the Register of Firms (Sec. 64). The Registrar is bound to amend the entry in the Register, if so directed by the Court as a consequence of its decision relating to a matter concerning the registered firm (Sec. 65). The Register of Firms shall be open to inspection by any person on payment of the prescribed fee (Sec. 66). The Registrar is bound to supply on demand, on payment of the prescribed fee, a copy of any entry in the Register of Firms (Sec. 67). The Register of Firms is a *conclusive proof* of the truth of the matters contained therein as against the parties signing the statements on the basis of which the Register is prepared. The third party, however, is allowed to challenge the fact of a statement and prove that it is false (Sec. 68). As such if a person's name does not appear in the Register of Firms as a partner, the third party may prove that he is a partner in the firm.

The Property of the Firm

Section 14 provides that subject to contract between the partners, the property of the firm includes all property and rights and interest in property originally brought into the stocks of the firm, or acquired by purchase or otherwise, by or for the firm, or for the purpose and in the course of the business of the firm, and includes also the goodwill of the business. If a partner brings in immovable property as his share of capital in the firm, that becomes the property of the firm even without a formal document of transfer in the name of the partnership firm. Similarly, property purchased with the partnership money is deemed to be the property of the firm even if a partner purchases that in his own name, unless a contrary intention appears from the conduct of the partner concerned.

ILLUSTRATIONS. *(a)* *A* and *B* are partners. *A* buys railway shares in his own name with the moneys and on account of the firm. The shares are partnership property.[6]

(b) *A* and *B* are partners. *A* buys land with partnership moneys, for his sole benefit. Thereafter *A* debits himself in the firm books and becomes a debtor to the firm for the amount of the purchase money. The land is not partnership property, because there was clearly a contrary intention (*Smith* vs *Smith*[7]).

TEST QUESTIONS

1. What is a partnership deed? State its main contents.
2. Discuss the various kinds of partners in a partnership firm.
3. Can a minor be admitted to a partnership? If so, what are the rules governing his rights and liabilities?

[6]*Exparte Hinds,* (1849), 3 De G & S. 613.
[7](1800), 5 Ves. 189.

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4. "As an agreement is an essential ingredient in a partnership, it follows that a minor cannot enter into an agreement of partnership." Discuss the above statement.

5. What is the procedure for the registration of a firm? Is such registration compulsory in respect of every firm? Can registration be done at any time during the continuance of the partnership firm?

6. "The Indian Partnership Act has effectively ensured the registration of firms without making it compulsory." Comment.

7. Is registration of partnership firms compulsory ? What is the procedure for the registration of a firm? What are the consequences of non-registration of a firm?

8. Write short notes on *(a)* Particular partnership, *(b)* Partner by estoppel, and *(c)* Partnership property.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. *A* introduces *B* to *C* as his partner, when in fact he is not so, and *B* keeps silence. On the faith of the representation *C* gives credit to *A*. *A* becomes insolvent. Can *C* make *B* liable?

[**Hint.** Yes, *C* can make *B* liable on the principle of 'estoppel or holding out.']

2. *A* and *B* are partners in a firm. *X* informs *Y* that he is also a partner in the firm of *A* and *B*. *Y* conveys this information to his friend *C*. *C*, believing *X* to be a partner of the firm of *A* and *B*, supplies goods on credit to the firm. Can *C* make *X* liable for the payment of the price of the goods remaining unpaid?

[**Hint.** Yes, *C* can make *X* liable for the payment of the price under the doctrine of 'holding out' because *C* has acted on the faith of the representation while giving credit to the firm. For making the doctrine of 'holding out' applicable it is not necessary that the representation must be made directly to the person so giving credit.]

3. *P* enters into a partnership with *R*, a minor, for the benefit of *R*. Is the partnership valid?

[**Hint.** No, the partnership is not valid. There must be a partnership in existence before a minor can be admitted to its benefits.]

4. *R*, a minor, was admitted to the benefits of a firm consisting of *A*, *B* and *C*, three adult partners. Within six months after attaining majority *R* gives public notice that he has become a regular partner. But *A* and *B* refuse to take him. Is *A* and *B*'s refusal justified?

[**Hint.** No, *A* and *B*'s refusal is not justified. *R* becomes a full-fledged partner as he has elected to become a partner within six months of his attaining majority, and other partners cannot refuse to take him as a partner.]

5. *A* and *B* were partners in an unregistered firm carrying on business of sugar manufacturing. *C* was advanced Rs 1,000 by the firm in lieu of his promise to supply sugarcane. There was short supply of sugarcane and Rs 700 were due from *C* to the partnership firm. The firm was afterwards dissolved and on division of assets of partnership this debt of Rs 700 was allotted to *A*. Can *A* sue *C* to recover the amount?

[**Hint.** Yes, *A* can sue *C* to recover the amount of Rs 700 because the unregistered firm or its partners are allowed to file a suit for the realisation of the assets

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upon the dissolution of the firm. The disability to sue disappears with the dissolution of the firm.]

6. *A* and *B* purchased a taxi to ply it in partnership. They had done business for about a year when *A*, without the consent of *B*, disposed of the taxi. *B* brought an action to recover his share in the sale proceeds. *A*'s only defence was that the firm was not registered. Will *B* succeed in his suit?

[**Hint**. Yes, *B* will succeed in his suit. As the business had been closed on the sale of the taxi, the suit in the question is for claiming share of the assets of a dissolved firm. Section 69(3) *(a)* specially protects the right of a partner of an unregistered firm to sue for the realisation of the property of a dissolved firm.]

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Chapter 23

Rights, Duties and Liabilities Of Partners

MUTUAL RIGHTS AND DUTIES

"Subject to the provisions of this Act, the mutual rights and duties of the partners of a firm may be determined by contract between the partners, and such contract may be express or may be implied by a course of dealing. Such contract may be varied by consent of all the partners, and such consent may be express or may be implied by a course of dealing" [Sec. 11(1)]. Thus, except in cases where the Partnership Act makes a mandatory provision, the partners are entitled to agree to any terms and provide for their mutual rights and duties.

Rights of Partners

Subject to contract between the partners, the Partnership Act confers the following rights upon the partners of a firm:

1. **Right to take part in the conduct of the business** [Sec. 12 *(a)*]. Every partner, irrespective of the amount of capital contribution, has an inherent right to take part in the conduct of the business of the firm. Although one may agree not to participate in the management of the business but the right of participation should be available to each partner.

2. **Right to be consulted** [Sec. 12 *(c)*]. Every partner has a right to be consulted and heard before any matter is decided. Any difference arising as to ordinary matters connected with the business may be decided by a majority of the partners. But no change may be made in the nature of the business or the constitution of the partnership, *e.g.*, admission of a new partner, without the consent of all the partners. The partnership deed may, however, provide that in all matters consent of all the partners is necessary or that all matters shall be decided by majority opinion. It may be noted that majority powers should be exercised in good faith for the benefit of the firm. If the majority of the partners decide to expel a partner without sufficient cause, the expulsion would be set aside (*Blisset* vs *Daniel*[1]).

[1](1853), 10 Hare 493.

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3. **Right of access to books** [Sec. 12*(d)*]. Every partner has a right to have access to and to inspect and copy any of the books of the firm.

4. **Right to share the profits** [Sec. 13 *(b)*]. Every partner, irrespective of the amount of capital contribution or business expertise, has a right to share equally in the profits earned by the firm.

5. **Right to interest on capital** [Sec. 13 *(c)*]. Where a partner is entitled to interest on capital subscribed by him, such interest shall be payable only out of profits.

6. **Right to interest on advances** [Sec. 13*(d)*]. Where a partner makes, for the purpose of the business, any payment or advance beyond the amount of capital he has agreed to subscribe, he is entitled to interest thereon at the rate of six per cent per annum.

7. **Right to indemnity** [Sec. 13 *(e)*]. Every partner has a right to claim indemnity from the firm in respect of payments made or liabilities incurred by him:

(a) in the ordinary and proper conduct of the business, and

(b) in doing such act, in an emergency, for the purpose of protecting the firm from loss, as would be done by a person of ordinary prudence, in his own case, under similar circumstances.

Duties of Partners

For the sake of clarity we shall be studying the duties of partners *inter-se* under the following two heads:

I. Absolute duties.

II. Qualified duties.

I. Absolute duties. These duties are imposed by law and are not subject to a contract to the contrary. Being mandatory in nature, these duties are applicable to all partnership and cannot be varied by agreement among the partners. The following are the absolute duties of partners:

1. *Duty to carry on the business to the greatest common advantage* (Sec. 9). Every partner is bound to carry on the business of the firm to the greatest common advantage. It implies that every partner must use his knowledge and skill for the benefit of the firm and not for his personal gain. He must conduct the business with the best of his ability and secure maximum benefits for the firm.

2. *Duty to be just and faithful inter-se* (Sec. 9). An ideal partnership is one where there is mutual trust and confidence, and spirit of helpfulness and goodwill among the partners. As such every partner must be just and faithful to his co-partners. He must observe utmost good faith and fairness towards other partners of the firm.

3. *Duty to render true accounts* (Sec. 9). Every partner must render true and proper accounts to his co-partners. It implies that each partner must be

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ready to explain the accounts of the firm and produce vouchers in support of the entries. No partner should think of making a secret profit at the expense of the firm.

4. *Duty to provide full information* (Sec. 9). Every partner must give full information of all things affecting the firm to his co-partners. A partner, being an agent of other partners, must not conceal any information concerning the firm from the other partners by reason of the law of agency as well. Law of agency provides that knowledge to the agent is deemed to be knowledge to the principal.

5. *Duty to indemnify for loss caused by fraud* (Sec. 10). A partner can cause loss to the firm by his neglect or want of skill or omission or fraud while acting in the ordinary course of business. The general practice is that where a partner acts *bonafide* the loss caused by his neglect or want of skill or omission is borne by the firm. But when the loss is caused by fraud committed against a third party by a partner, the same must be recovered from the guilty partner and cannot be shared among all the partners. Section 10 gives statutory recognition to this rule and provides that "every partner must indemnify the firm for any loss caused to it by his fraud in the conduct of the business of the firm." The object of this provision is to discourage partners to deal fraudulently in the conduct of the business.

6. *Duty to be liable jointly and severally* (Sec. 25). Every partner is liable, jointly with all the other partners and also severally, to third parties for all acts of the firm done while he is a partner. The liability of all the partners is not only joint and several but is also unlimited. Thus if a firm fails to pay a creditor, he may at his discretion bring an action against some or all the partners for the whole amount.

7. *Duty not to assign his interest* (Sec. 29). No partner can assign or transfer his partnership interest to any other person so as to make him a partner in the business without the consent of all other partners. He can, however, assign his share of the profit and his share in the assets of the firm but the transferee shall not have any right to interfere in the conduct of the business.

II. **Qualified duties.** Qualified duties are those which depend upon the contract between the partners and it is only in the absence of a contract to the contrary that these duties, as laid down by the Partnership Act, are applicable. In other words, the partners are free to vary these duties by mutual agreement, express or implied, and if the partnership agreement is silent then only the duties contained in the Partnership Act will be the duties of the partners. Subject to contract between the partners, the Partnership Act prescribes the following duties of partners *Inter-se:*

1. *Duty to attend diligently to his duties* [Sec. 12*(b)*]. Every partner is bound to attend diligently to his duties in the conduct of the business.

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2. *Duty to work without remuneration* [Sec. 13*(a)*]. A partner is not entitled to receive remuneration for taking part in the conduct of the business:

3. *Duty to contribute to the losses* [Sec. 13*(b)*]. The partners are bound to contribute equally to the losses sustained by the firm, irrespective of the amount of capital contribution by each one of them.

4. *Duty to indemnify for willful neglect* [Sec. 13*(f)*]. Every partner is under a duty to indemnify the firm for any loss caused to it by his wilful neglect in the conduct of the business of the firm. The expression 'wilful neglect' means the failure to perform a duty, or to do something which a partner ought to have done, intentionally and deliberately. An act done in good faith and *bonafide* or a mere error of judgment cannot be termed as wilful neglect.

5. *Duty to use firm's property exclusively for the firm* (Sec. 15). It is the duty of every partner to use the property of the firm exclusively for the purposes of the business. No partner should use partnership property for his personal benefit.

6. *Duty to account for personal profits derived* [Sec. 16*(a)*]. If a partner derives any profit for himself from any transaction of the firm or from the use of the property or business connection of the firm or the firm name, he must account for that profit and pay it back to the firm.

7. *Duty not to compete with the business of the firm* [Sec. 16*(b)*]. A partner must not carry on any business which is similar to or likely to compete with the business of the firm. If he does that, he is bound to account for and pay to the firm all profits made by him in that business. A partner may, however, carry on a non-competing business and may retain the profits of that business to himself.

RELATIONS OF PARTNERS TO THIRD PARTIES

We have already seen that mutual agency between the partners is one of the essential elements of a partnership. And, therefore, each partner is both a principal and an agent for the other and each is bound by the others's contract in carrying on the trade. Section 18 declares that from the point of view of the third parties a partner is an agent of the firm for the purposes of the business of the firm. As such even if only one partner acts on behalf of the firm, the third party can make all the partners of the firm liable. It is important to note that one partner can make other partners liable towards the third parties only if he acts within the scope of his *express* or *implied* authority.

Express Authority of a Partner

When a partner is expressly authorised by an agreement of all the

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partners to do certain acts on behalf of the firm, it is called express authority of a partner. The firm is bound by all acts of a partner done within the scope of his express authority even if the acts are not within the scope of the partnership business.

Implied Authority of a Partner

The firm is also bound by all acts of a partner done within the scope of his implied authority. An implied authority of a partner can be inferred from the circumstances of the case. Generally speaking, such acts of a partner which are incidental to or usually done in the course of the proper conduct of the business come within the scope of his implied or apparent or ostensible authority.

Sections 19(1) and 22 define the scope of the implied authority of a partner. Accordingly, for an act to be covered within the implied authority it is necessary that:

(a) the act should be done for carrying on the business of the kind carried on by the firm;

(b) the act should be done in the usual way of such business; and

(c) the act must be done in the firm name or in any other manner expressing or implying an intention to bind the firm.

Thus the implied authority of a partner cannot extend to his acts done beyond the scope of the business of the firm. If in a firm of cloth merchants, a partner buys sugar, that will be outside the implied authority of the partner for which the firm cannot be bound. In case of trading or commercial firm, a partner, in the exercise of his implied authority, can bind the firm by any of the following acts:

(i) buying and selling goods, on behalf of the firm, in which the firm deals;

(ii) receiving payments of the debts due to the firm and giving valid receipts for them;

(iii) contracting debts and paying debts on behalf of the firm;

(iv) settling accounts with persons dealing with the firm;

(v) employing servants for the partnership firm;

(vi) drawing cheques, accepting or endorsing bills of exchange and promissory notes in the name of the firm;

(vii) pledging movable property of the firm;

(viii) suing on behalf of the firm and defending suits in the name of the firm.

Statutory restrictions on implied authority [Sec. 19(2)]. Certain acts have been statutory excluded from the scope of implied authority of a partner and a partner cannot, therefore, bind the firm by such acts unless the usage or custom of trade permits him or all the other partners expressly

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authorise him. As such the third party should ascertain as to whether the partner is authorised and if the third party deals without ascertaining this fact, he cannot make the firm liable.

Section 19(2) contains the list of acts regarding which a partner does not have an implied authority unless there is usage or custom or contract to the contrary. Accordingly, a partner cannot:

(i) submit a dispute relating to the business of the firm to arbitration;

(ii) open a banking account on behalf of the firm in his own name;

(iii) compromise or relinquish any claim or portion of a claim by the firm;

(iv) withdraw a suit or proceeding filed on behalf of the firm;

(v) admit any liability in a suit or proceeding against the firm;

(vi) acquire immovable property on behalf of the firm;

(vii) transfer immovable property belonging to the firm; or

(viii) enter into partnership on behalf of the firm.

Extension or restriction of partner's implied authority (Sec. 20). The partners in a firm may, by contract among themselves, extend or restrict the implied authority of any partner. When an act is done by a partner on behalf of the firm in the exercise of his extended implied authority, the person seeking to make the firm liable on such extended authority, must prove such extension to his knowledge. On the other hand, when an act is done by a partner on behalf of the firm for which his implied authority has been restricted by a contract between the partners, such act binds the firm *vis-a-vis* third party notwithstanding any such restriction, unless the third party has the knowledge of the restriction.

ILLUSTRATION. The partnership deed of a trading firm placed a restriction on the authority of the partners to borrow money. One of the partners borrowed money and accepted a bill of exchange. It was held that since the third party did not know of the restriction, the firm was liable towards such third party (*Motilal* vs *Unnao Commercial Bank*[2]).

Partner's Authority in an Emergency

Section 21 extends the authority of a partner in an emergency and lays down that "a partner has authority, in an emergency, to do all such acts for the purpose of protecting the firm from loss as would be done by a person of ordinary prudence, in his own case, acting under similar circumstances, and such acts bind the firm."

Effect of Admission by Partner

An admission or representation made by a partner concerning the af-

[2](1930), 32 Bom. L.R. 1571.

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fairs of the firm is evidence against the firm, if it is made in the ordinary course of business (Sec. 23).

Effect of Notice to Acting Partner

Notice to a partner, who habitually acts in the business of the firm, of any matter relating to the affairs of the firm operates as notice to the firm, except in the case of a fraud on the firm, committed by or with the consent of that partner (Sec. 24). Thus, in order that notice to one partner operates as a notice to the whole firm it is necessary that the notice must be given to an active partner and not to a dormant or sleeping partner. As such once a notice is served on an acting partner, other partners cannot plead ignorance of the same. But this general rule is subject to one important exception. When a partner is a party to a fraud upon the firm, his knowledge of such fraud, and of the facts and circumstances connected therewith, cannot be said knowledge of the firm. For example, if one of the partners knows that the vendor, who is his relative, is defrauding the firm by supplying goods of short weight, that knowledge would not prevent the remaining partners from suing the vendor for his fraud.

Liability of Partners to Third Parties

The liability of partners to third parties may be divided into three categories:

1. Liability of a partner for acts of the firm.
2. Liability of the firm for wrongful acts of a partner.
3. Liability of the firm for misapplication by partners.

1. **Liability of a partner for acts of the firm** (Sec. 25). Every partner is liable, jointly with all the other partners and also severally, for all acts of the firm done while he is a partner. Further, the liability of all the partners is unlimited. By virtue of joint and several liability, a creditor of the firm has several causes of action. He can sue all partners together, or can sue them separately (in successive actions if necessary). As between the partners themselves, the partner paying for more than his share of the liability may claim contribution from the others according to the terms of the partnership agreement.

2. **Liability of the firm for wrongful acts of a partner** (Sec. 26). Where, by the wrongful act or omission of a partner acting in the ordinary course of the business of a firm, or with the authority of his partners, loss or injury is caused to any third party, or any penalty is incurred, the firm is liable therefore to the same extent as the partner. The wrongful act may be tort, fraud or negligence. It is important to note that although the firm is liable to the third party for loss caused to him by *fraud* committed by a partner, but, as between the partners, as per Section 10, the same must be borne by the partner committing the fraud and cannot be shared among

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all the partners. Of course, in the case of loss caused by tort or negligence of any partner all partners are liable *inter-se* in their profit sharing ratio and the firm is liable to the third party as it is liable in the case of fraud.

ILLUSTRATION. One of the partners, who was an active partner in the firm, knowing that the goods were stolen ones, purchased and sold them in the name of the firm. The other partner, who was a sleeping partner, knew nothing whatever about the theft. Both the partners were held liable for the tort of 'conversion' to the owner of the goods (*Hurruck Chand* vs *Gobind Lal Khetry*[3]).

3. **Liability of the firm for misapplication by partners** (Sec. 27). Where *(a)* a partner acting within his apparent authority receives money or property from a third party and misapplies it, or *(b)* a firm in the course of its business receives money or property from a third party, and the same is misapplied by any of the partners while it is in the custody of the firm, the firm is liable to make good the loss.

Under this Section it has been recognised that the firm must be treated as receiving what any partner receives in the ordinary course of the business of the firm. Accordingly, if any partner misappropriates any money or property which he might have received either in repayment of a debt or as a loan on account of the firm, the third party can make the firm or any of the partners liable for the same.

INCOMING AND OUTGOING PARTNERS

Incoming Partner (Sec. 31)

Subject to contract between the partners, no person can be admitted as a partner into a firm without the consent of all the existing partners. Mutual confidence and trust among the partners being an essential ingredient of an ideal partnership it is very much natural that there must be a consent of all the partners to the introduction of a new partner, unless the partners have already agreed otherwise.

Liability of a incoming partner. A new partner becomes liable for the debts and acts of the firm only from the date he is admitted as a partner. He cannot be held liable for the acts of the old firm. A new partner may, however, agree to be liable for debts existing prior to his admission but such agreeing will not give to a prior creditor the right of suing him because of 'absence of privity of contract.' He will be liable to other co-partners only. The creditors can make him liable if he had agreed with them, expressly or impliedly, for being liable towards them for the past debts.

Retirement of a Partner (Sec. 32)

A partner is said to retire when the surviving partners continue to carry

[3](1906), 12 Cal. W.N. 1053.

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on the business of the firm, and the member retiring ceases to be a partner.

Method of retirement. In case of a "particular partnership" a partner may retire with the consent of all the other partners, unless otherwise agreed. In case of "partnership at will" a partner may retire by giving a notice in writing to all the other partners of his intention to retire, unless otherwise agreed.

Liability of a retiring partner. A retiring partner continues to be liable for the acts of the firm done before his retirement. He may, however, free himself from his liability towards third parties for the debts of the firm incurred before his retirement by an agreement with such third parties and the partners of the reconstituted firm discharging the outgoing partner from all liabilities. The remaining partners alone cannot give this freedom to the retiring partner. He may be discharged only if the creditors agree.

A retiring partner also continues to be liable for the acts of the firm, even after retirement, until public notice is given of the fact of retirement. Similarly, the partners of the reconstituted firm continue to be liable for the acts of the retired partner though done after retirement, until public notice is given of the retirement. Such a public notice may be given either by the retiring partner or by any partner of the reconstituted firm. A dormant or sleeping partner, however, need not give any such notice.

Rule of mis-joinder of parties. The rule of law that 'separate suit for separate contract and hence no two distinctly liable parties can be sued under one suit' is known as the rule of mis-joinder of parties. This rule should be remembered while making an incoming or outgoing partner liable for the debts of the firm. For example, if *A, B, C* and *D* are partners and *D* retires without giving public notice and *E* is admitted to the partnership on the same very day, *i.e.*, on 1 July 1993, an innocent creditor, who advances money to the firm after 1 July 1993, can make all of them, *i.e., A, B, C, D* and *E* individually liable or existing partners, *i.e., A, B, C,* and *E* jointly liable. He cannot make *A, B, C, D* and *E* jointly liable in one suit because all of them were never partners of the same partnership at one time.

Restrictions imposed on a retiring partner. Section 36 has imposed the following restrictions on a retiring partner:

1. He must not use the name of the firm. Although he has a right to carry on a competing business.

2. He cannot represent himself to the public as carrying on the business of the old firm, *e.g.*, as a branch or otherwise.

3. He must not convass the old customers of the firm.

Some of these restrictions, however, may be removed by a contract between the outgoing and the other partners. On the other hand, additional restrictions may be imposed by means of a contract, *e.g.*, the retiring partner may be prohibited from starting a competing business within a specified period or within specified local limits.

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Right of a retiring partner in certain cases to share subsequent profits (Sec. 37). If any member of a firm ceases to be a partner and the business of the firm is carried on without any final settlement of accounts with him, then, in the absence of a contract to the contrary, he or his legal representative has an option either:

(a) to claim such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm (*i.e.*, to claim profits in capital ratio); or

(b) to claim interest at the rate of six per cent per annum on the amount of his share in the property of the firm.

Expulsion of a Partner (Sec. 33)

A partner may be expelled from a firm by majority of the partners only if, *(a)* the power to expel has been conferred by contract between the partners, and *(b)* such a power has been exercised in good faith for the benefit of the firm. The partner who is being expelled must be given reasonable notice and opportunity to explain his position and to remove the cause of his expulsion *(Nemi Dass* vs *Kunj Behari*[4]).

If the expulsion is *mala fide* the same is void and the irregularly expelled partner will not cease to be a partner. He may get himself reinstated with the help of the court. Of course he cannot claim any damages for wrong expulsion.

The rights and liabilities of an expelled partner are exactly the same as that of a retiring partner.

Insolvency of a Partner (Sec. 34)

Where a partner in a firm is adjudicated as insolvent, he ceases to be a partner on the date on which the order of adjudication is made, whether or not the firm is thereby dissolved will depend upon the agreement of partnership between the partners.

Where under a contract between the partners the firm is not dissolved by the adjudication of a partner as an insolvent, the estate of a partner so adjudicated is not liable for any act of the firm and the firm is not liable for any act of the insolvent, done after the date on which the order of adjudication is made. It is to be noted that, unlike a retiring partner, an insolvent partner is not required to give a public notice of his being adjudicated insolvent in order to absolve himself from liability for future acts of the firm.

The insolvent partner's share in the firm's assets will be used for firm's debts first and whatever remains will be utilised for the insolvent partner's personal debts.

[4]A.I.R. (1928), Oudh. 424.

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Death of a Partner (Sec. 35)

Although on the death of a partner a firm is dissolved, but if the other partners so agree the firm may not be dissolved [Sec. 42*(c)*]. Where a firm is not dissolved, the estate of a deceased partner is not liable for any act of the firm done after his death. His estate is liable only for liabilities undertaken during his life time. No public notice of death is required to relieve the deceased partner's estate from future liabilities.

It is important to note that the provisions of Section 36 (Restrictions imposed on retiring partner) and Section 37 (Right of retiring partner to share subsequent profits in certain cases), which have been discussed under the heading 'Retirement of a Partner," are also applicable when partner ceases to be a partner by expulsion, insolvency or death.

Revocation of Continuing Guarantee by Change in Firm (Sec. 38)

A continuing guarantee given to a firm, or to a third party in respect of the transactions of a firm, is, in the absence of agreement to the contrary, revoked as to future transactions from the date of any change in the constitution of the firm.

Mutual Rights and Duties of Partners after Change in the Firm [Sec. 17*(a)*]

Subject to contract between the partners, where a change occurs in the constitution of a firm (*i.e.*, where a new partner is admitted or where a partner ceases to be a partner by retirement, expulsion, insolvency or death), the mutual rights and duties of the partners in the reconstituted firm remain the same as they were immediately before the change, as far as may be possible. Thus, where *A, B* and *C* are partners sharing profits in the ratio of 4:3:3 and *D* is admitted as a new partner who is to get 1/4 of the profits, the remaining 3/4 of the profits will be distributed between *A, B* and *C* in their old ratio of 4:3:3. Sometimes a new partner may be admitted without specifying even the profit sharing ratio of the new partner. In that case the new partner should be deemed to share equally in the profits of the business[5] and the remainder should be distributed among the old partners in their *inter-se* old profit sharing ratio. For example, if *A, B, C* and *D* are partners sharing profits in the ratio of 4:3:2:1 and *E* is admitted as a new partner without any terms as to sharing of profits, then *E* is entitled to1/5 of the profits and the remaining 4/5 will be distributed between *A, B, C* and *D* in the ratio of 4:3:2:1. In practice, usually, every thing is settled among the partners in black and white by means of a partnership deed about their rights and duties whenever one or the other change in the constitution of the firm takes place.

[5]In the absence of a contract to the contrary, the partners are entitled to share equally in the profits earned [Sec. 13*(b)*].

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TEST QUESTIONS

1. Discuss the mutual rights and duties as between the partners in the absence of any express contract between them.

2. What is the nature and extent of a partner's authority to bind the firm by his acts?

3. What is meant by implied authority of a partner? What are the statutory restrictions on a partner's implied authority?

4. What is the extent of the implied authority of a partner? Are third parties affected by restrictions placed on such implied authority?

5. State the liabilities of *(a)* a partner for the acts of the firm, *(b)* of the firm for wrongful acts of a partner, and *(c)* of the firm for misapplication of money or property by a partner.

6. How and when may a partner retire? What are the rights and liabilities of a retiring partner?

7. *(a)* Can a new partner be introduced in a firm? Discuss the liability of a new partner.

(b) When may a partner be expelled? Discuss the rights and liabilities of an expelled partner.

8. Write notes on: *(a)* Insolvency of a partner, *(b)* Death of a partner, and *(c)* Mutual rights and duties of partners after the reconstitution of a firm.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *X* and *Y* are partners in a cloth business. *X* orders in firm's name and on the firm's letter-head to be supplied with two bags of wheat at his residence. Is the firm liable to pay the debt?

[**Hint**. No, the firm is not liable to pay because *X*'s act in question is beyond the scope of his implied authority for which the firm cannot be bound.]

2. *A, B, C* and *D* established a partnership for refining sugar. *A* was considered expert in the job of buying sugar. Thus *A* was entrusted with the duty of purchasing sugar for the firm. *A* himself was a wholesale dealer in sugar. He, unknown to his co-partners, supplied to the firm, at the market price, with sugar previously bought by himself from his own resources when the price was lower, and he so made considerable profit. *B, C* and *D* sued for the profits thus made by him. Is *A* accountable?

[**Hint**. Yes, *A* is accountable to the firm for the profit thus made by him because he has failed in his duty to observe utmost good faith towards other partners and to make fullest disclosure of all facts to them. (*Bentley* vs *Craven*)]

3. *A, B* and *C* agreed to form a partnership. The partnership deed, *inter-alia,* provided that all the three shall share the profits equally. Afterwards they carried on the partnership business for many years, *A* receiving one-half of the net profits and the other half being equally divided between *B* and *C*, to which *B* and *C* never objected. The partnership developed some differences and as such *B* and *C* file a

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suit for their share of profits for the past years on the basis of the partnership deed. Decide.

[**Hint.** *B* and *C's* suit is not maintainable because by accepting profits for past many years in a ratio different from the agreed ratio they have impliedly consented to the variation in the contract (*i.e.*, partnership deed). Section 11(1) expressly provides that the contract between the partners may be varied by consent of all the partners, and such consent may be expressed or may be implied by a course of dealing.]

4. *A* and *B* are working in partnership as chartered accountants. *C* gives Rs 10,000 to *A* for investment in some good security. *A* does not tell anything to his co-partner *B* about it and misappropriates the money. *C* files a suit on the firm for the recovery of his Rs 10,000. Will he succeed?

[**Hint**. No, *C* will not succeed. The firm cannot be made liable because it is no part of the ordinary business of chartered accountants to receive money to be invested at their discretion. Of course an action will lie against *A* individually.]

5. *A* and *B* are partners in a business. *A*, without the knowledge of *B*, acting within the general scope of his authority as a partner bribed *C*'s clerk and induced him, in breach of his duty to his employer, to disclose some secrets relating to *C*'s business. *C*, as a result suffers a loss. Is *B* liable for the acts of *A*?

[**Hint.** Yes both *A* and *B* are liable for any loss that accrues to *C*. In the instant case, since the wrong is done within the scope of the authority of the wrong-doing partner, the other partner is also liable. (*Hamlyn* vs *John Houston & Co.)*]

6. *A, B* and *C* are partners. An order is placed with *D* for supplying a certain quantity of goods to the firm on credit. Before *D* could supply the goods *C* died. *D* supplies the goods after *C*'s death, being totally ignorant about the fact of *C*'s death. *A* and *B* subsequently become insolvent. Can *D* make *C*'s estate liable for his debt?

[**Hint.** No, *D* cannot make *C*'s estate liable for his debt. The debt accrues after the delivery of goods which has been made after *C's* death, and the estate of a deceased partner is not liable for debts of the firm contracted after his death irrespective of no public notice of death.]

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Chapter 24

Dissolution of Partnership Firm

The Indian Partnership Act distinguishes between:

(a) Dissolution of firm, and

(b) Dissolution of partnership.

Section 39 provides that the dissolution of partnership between all the partners of a firm is called the 'dissolution of the firm.'

When one or more partners cease to be partners of the firm but others continue the business in partnership, it is called 'dissolution of partnership.' In this case, the firm is reconstituted without any dissolution.

It follows that the dissolution of the firm necessarily involves the dissolution of partnership as well, but the dissolution of the partnership may or may not involve the dissolution of the firm. For example, where *A, B* and *C* were partners in a firm and *A* died, retired or adjudged insolvent, the 'partnership firm' as well as the 'partnership' would come to an end in the absence of a contract to the contrary. But if the partners have agreed that the death, retirement or insolvency of a partner would not dissolve the firm, then on the happening of any of these events, 'partnership' would certainly come to an end, although the 'firm' may continue under the same firm name.

Modes of Dissolution of a Firm

A firm may be dissolved in any one of the following ways:

1. **By agreement** (Sec. 40). A firm may be dissolved with the consent of all the partners or in accordance with a contract between the partners. Partnership is created by contract, it can also be terminated by contract.

2. **By notice** (Sec. 43). Where the partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm. A notice of dissolution once given cannot be withdrawn without the consent of other partners (*Jones* vs *Lloyd*[1]). The firm is dissolved as from the date mentioned in the notice as the date of dissolution or, if no date is so mentioned, as from the date of the communication of the notice.

[1](1874), L.R. 18 Eq. 263.

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3. **On the happening of certain contingencies** (Sec. 42). Subject to contract between the partners, a firm is dissolved:

(a) if constituted for a fixed term, by the expiry of that term;

(b) if constituted to carry out one or more adventures or undertakings, by the completion thereof;

(c) by the death of a partner; and

(d) by the adjudication of a partner as an insolvent.

The partnership agreement may provide that the firm will not be dissolved in any of the aforementioned circumstances. Such a provision is valid.

4. **Compulsory dissolution** (Sec. 41). A firm is compulsorily dissolved under any of the following circumstances: *(a)* When all the partners, or all the partners but one, are adjudged insolvent; or *(b)* When some event has happened which makes it unlawful for the business of the firm to be carried on *or* for the partners to carry it on in partnership (*e.g.*, when any partner, who is a citizen of a foreign country, becomes an alien enemy because of the declaration of war between his country and India). Where, however, a firm is carrying on more than one adventures or undertakings, the illegality of one or more shall not of itself cause the dissolution of the firm in respect of its lawful adventures or undertakings.

5. **Dissolution by the Court** (Sec. 44). Dissolution of a firm by the Court is necessitated when there is a difference of opinion between the partners regarding the matter of dissolution. For example, where one of the partners has become insane[2], some of the partners may be willing to continue the firm and share profits with the insane partner, while the other partner(s) may be insisting on the dissolution of the firm. Obviously in these circumstances intervention by the Court becomes necessary. On receiving the petition for the dissolution of the firm the Court is not bound to decree dissolution and it enjoys complete discretion in the matter. It may or may not order for the dissolution of the firm depending upon the merits of each case.

Section 44 enumerates the various grounds on which a petition may be made to the court for the dissolution of the firm. The Section lays down that at the suit of a partner, the Court *may* dissolve a firm on any of the following grounds:

(a) Insanity. When a partner becomes insane. In this case the Section permits not only any of the partners but also the next friend of the insane partner to file the suit for dissolution of the firm.

(b) Permanent incapacity. When a partner, other than the partner suing, becomes permanently incapable of performing his duties as partner.

[2]Of course an insane cannot become a partner initially as he has no capacity to contract, but if one becomes insane during continuance of the partnership the firm can continue.

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(c) Misconduct. When a partner, other than the partner suing, is guilty of misconduct, which is likely to affect prejudicially the carrying on of the business of the firm. It is not necessary that the misconduct which is made the ground of dissolution should be connected with partnership business. Conviction for travelling without ticket or the adultery by one partner with another partner's wife are good grounds for the dissolution of the firm. Under this clause the suit cannot be brought by the guilty partner for that would allow him an excuse for getting a firm dissolved at his will.

(d) Persistent breach of agreement. When a partner, other than the partner suing, commits frequently breaches of the partnership agreement or otherwise so conducts himself in matters relating to the business that other partners find it impossible to carry on the business in partnership with him. Taking away the books of accounts, using firm's monies for his private debts, continuous quarrelling with other partners are good grounds for the dissolution.

(e) Transfer of interest. When a partner, other than the partner suing, has transferred the whole of his interest in the firm to a third party or has allowed his share to be sold in execution of a decree. Transfer or assignment of partner's interest does not by itself dissolve the firm. But the other partners may apply to the Court to dissolve the firm if such a transfer occurs.

(f) Continuous losses. When the business of the firm cannot be carried on except at a loss.

(g) Just and equitable. When on any other ground the Court considers it just and equitable that the firm should be dissolved, for example, if partners are not on speaking terms.

Consequences of Dissolution

1. **Continuing liability of partners after dissolution** (Sec. 45). Notwithstanding the dissolution of a firm, the partners continue to be liable as such to third parties for any act done by any of them which would have been an act of the firm if done before the dissolution, *until public notice is given of the dissolution.* The notice may be given by the firm or any partner. It must be given to the Registrar of Firms, in case of registered firms, in the local Official Gazette and in at least one vernacular newspaper circulating in the district where the firm's principal place of business is situated (Sec. 72). In the absence of public notice of dissolution, however, the estate of a partner, who dies, or who is adjudicated an insolvent, or in case of a retiring partner, who is not known to the outside world to be a partner, is not liable for acts done after the date on which he ceases to be a partner.

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2. **Continuing authority of partners for purposes of winding up** (Sec. 47). After the dissolution of the firm the authority of each partner to bind the firm, and other mutual rights and obligations of the partners, continue so far as may be necessary for the following two purposes:

(a) to wind up the affairs of the firm, *e.g.*, disposing of the property, realising amount due from debtors and paying to creditors and so on; and

(b) to complete transactions begun but unfinished at the time of the dissolution, *e.g.*, taking delivery of the goods ordered before dissolution and paying for them.

The firm, however, is not bound by such acts of a partner who has been adjudicated insolvent.

3. **Right of partners to enforce winding up** (Sec. 46). On the dissolution of a firm every partner or his representative is entitled to have the property of the firm realised and applied in payment of the debts and liabilities of the firm, and to have the surplus distributed among the partners or their representatives according to their rights.

4. **Liability to share personal profits** (Sec. 50). So long as the affairs of the dissolved firm are in process of winding up, it is still the duty of every partner not to make any personal profit out of transactions concerning the firm. A partner, therefore, must account to the firm for every benefit so derived by him and must share it with other partners.

5. **Return of premium** (Sec. 51). Where a partner has paid a premium on entering into partnership for a fixed term, and the firm is dissolved before the expiration of that term, such a partner shall be entitled to repayment of 'rateable amount of premium' for the unexpired period except where the dissolution has been caused:

(a) by the death of a partner;

(b) by the misconduct of the partner so admitted; or

(c) by mutual agreement of all the partners containing no provision for the return of premium.

6. **Rights where partnership contract is rescinded for fraud, etc.** (Sec. 52). A contract of partnership like any other contract may be rescinded on the ground of fraud or misrepresentation. The partner misled also has a right to claim damages for fraud. This Section grants the following further rights to the partner thus rescinding the contract:

(a) He has a right of lien on the surplus of the assets of the firm remaining after the debts of the firm have been paid, for any sum paid by him for the purchase of a share in the firm and for any capital contribution by him.

(b) He is entitled to rank as a creditor of the firm in respect of any payment made by him towards the debts of the firm.

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(c) He has also the right to claim indemnity from the partners guilty of the fraud or misrepresentation against all the debts of the firm.

7. **Right to impose restrictions.** In the absence of an agreement to the contrary, each partner or his representative is entitled to restrain the other partners from carrying on a similar business in the name of the firm or from using the property of the firm for their own benefit, until the affairs of the firm have been completely wound up. However, where a partner or his representative has bought the goodwill of the firm he can use the firm name. (Sec. 53)

Further, the partners in anticipation of or upon dissolution of the firm, can agree that some or all or them will not carry on a business similar to that of the firm within a specified period or within specified local limits. Such an agreement shall be valid and not void on the ground of restraint of trade, if the restrictions imposed are reasonable. (Sec. 54)

Mode of Settling Accounts upon Dissolution

The settlement of accounts between partners upon dissolution of a firm is to be affected in the manner provided for in the partnership agreement. In the absence of any agreement between the partners regarding the method by which accounts of the partnership are to be settled on its dissolution, the following rules stated in Section 48 of the Partnership Act shall apply:

1. Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly, if necessary, by the partners individually in the proportions in which they were entitled to share profits.

ILLUSTRATION. *A*, *B* and *C* are three partners in a firm. Their capital contributions are *A*- Rs 20,000, *B*-Rs 5,000 and *C*-Rs 1,000. They share profits and losses equally. Upon dissolution it is found that realisable assets are Rs 30,000 and debts payable are Rs 10,000. Thus after paying the debts, assets available for partners are worth only Rs 20,000 and as such there is a capital deficiency of Rs6,000. Each partner must contribute Rs 2,000 each.

2. The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:

(i) In paying the debts of the firm to third parties.

(ii) In paying to each partner rateably what is due to him from the firm for advances as distinguished from capital.

(iii) In paying to each partner rateably what is due to him on account of capital.

(iv) The residue, if any, shall be divided among the partners in the proportions in which they were entitled to share profits.

Firm debts vs private debts. Where both debts due from the firm and

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debts due from a partner in his individual capacity exist, the following rules stated in Section 49, as to settlement of such debts shall apply:

(a) The property of the firm shall be applied for payment of the firm's debts first, and if there is any surplus, then the share of each partner shall be applied in payment of his separate debts or paid to him.

(b) The separate property of any partner shall be applied first in the payment of his separate debts, and the surplus, if any, may be utilised in the payments of the debts of the firm.

Loss arising from insolvency of a partner. When a partner is unable to contribute towards the deficiency of his capital account he is said to be insolvent and the loss arising out of his insolvency is called 'capital loss.' In the absence of any contract to the contrary, such a capital loss is to be borne by other solvent partners in accordance with the principle laid down in *Garner* vs *Murray*.[3] In that case it was held that the solvent partners have to bear the loss arising from insolvency of a partner in their *capital ratio.*

Capital ratio explained.[4] Partners are free to have fixed or fluctuating capital in the firm. If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, *etc.*, are done through Current Account, which may have debit or credit balance and insolvency loss is distributed in the ratio of *fixed capitals.* But if capitals are not fixed and all transactions relating to drawings, profits, interest, *etc.*, are passed through Capital Accounts then Balance Sheet of the business shall not exhibit Current Accounts of the partners and capital ratio will be determined *after* adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capital and drawing to the date of dissolution but *before* adjusting profit or loss on Realisation Account. If some partner is having a debit balance on his Capital Account and is not insolvent then he cannot be called upon to bear loss on account of the insolvency of other partner.

Sale of Goodwill after Dissolution (Sec. 55)

The rules relating to sale of goodwill upon dissolution of a firm are as follows:

1. While winding up the affairs of the firm after dissolution, the goodwill shall, subject to contract between the partners, be included in the assets, and it may be sold either separately or alongwith other property of the firm.

[3](1904), 1 Ch. 57.
[4]Cf. R.L. Gupta, *Advanced Accountancy*,, Vol. I, 3rd Edn. 1975, p. 3.138

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2. After the sale of goodwill any partner of the dissolved firm *(i)* can carry on a business competing with that of the buyer of goodwill, and *(ii)* can advertise such business. But any partner of the dissolved firm may make an agreement with the buyer that such partner will not carry on a business similar to that of the firm within a specified period or within specified local limits, provided the restrictions imposed are reasonable.

3. In the absence of a contract to the contrary, the seller of goodwill, that is, partners of the dissolved firm cannot *(i)* use the firm name, *(ii)* represent themselves as carrying on the business of the old firm, and *(iii)* cannot solicit the customers of the old firm.

TEST QUESTIONS

1. What are the different modes in which a firm may be dissolved?
2. Distinguish between dissolution of firm and dissolution of partnership and discuss the grounds on which a partnership firm may be dissolved by the court.
3. What are the consequences of the dissolution of a firm?
4. State the rules governing settlement of accounts of the firm, and sale of goodwill, after dissolution.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. *A* and *B* are partners in a firm. The partnership deed, *inter-alia,* provides that partnership can be terminated 'by mutual agreement only.' *B* alone wants to terminate the partnership. Can he do so?

[**Hint**. No, *B* cannot compel *A* to terminate the partnership.]

2. *A, B* and *C* started a cloth business in Chandni Chowk on 1 January 1983, for a period of five years. The business resulted in a loss of Rs 10,000 in the first year, Rs 15,000 in the second year and Rs 18,000 in the third year. *B* and *C* wish to dissolve the firm while *A* wants to continue the business. Advise *B* and *C*.

[**Hint**. *B* and *C* are advised to make a petition to the court for the dissolution of the firm on the ground that the firm cannot be carried on except at a loss. Since the firm was constituted for a fixed term of five years it cannot be dissolved without the consent of all the partners and as such *B* and *C* cannot compel *A* to dissolve the firm.]

3. *A* and *B* form a trading partnership for five years. After two years *A* is convicted of travelling on the railway without a ticket. *A* files a suit for the dissolution of the firm on the ground of his own misconduct. Will he succeed? Will your answer be different if *B* files the suit on the ground of *A*'s misconduct?

[**Hint**. *A* cannot succeed, for the court will not interfere at the suit of a partner who is himself guilty of misconduct. Of course, the court will dissolve the firm on the suit of *B*.]

4. A firm of grocers dissolved partnership and sold the goodwill of their business to *X, Y* and *Z*, who are now carrying on the same business at the same address.

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Subsequently, the old partners *P*, *Q* and *R* again entered into partnership as grocers, set up a competing business next door to *X*, *Y* and *Z*, and solicited customers of their old firm. Advise *X*, *Y* and *Z*.

[**Hint.** *X*, *Y* and *Z* are entitled to restrain by injunction the sellers of goodwill, namely *P*, *Q* and *R* from soliciting customers of their old firm. However, *P*, *Q* and *R* are within their rights to start a business competing with that of the buyers of goowill.]

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PART IV

Law of Negotiable Instruments

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Chapter 25

Negotiable Instruments

The law relating to "negotiable instruments" is contained in the Negotiable Instruments Act, 1881,[1] as amended up-to-date.[2] The Act extends to the whole of India. It deals with three kinds of negotiable instruments, *i.e.*, Promissory Notes, Bills of Exchange and Cheques, these being in most common use. The provisions of the Act also apply to 'hundis' (an instrument in oriental language), unless there is a local usage to the contrary. Other documents like Treasury Bills, dividend warrants, share warrants, bearer debentures, Port Trust or Improvement Trust Debentures, Railway bonds payable to bearer, *etc.*, are also recognised as negotiable instruments either by mercantile custom or under other enactments like the Companies Act, 1956, and therefore, Negotiable Instruments Act is applicable to them.

Definition

The word *negotiable* means 'transferable by delivery,' and the word *instrument* means 'a written document by which a right is created in favour of some person.' Thus, the term "negotiable instrument" literally means 'a written document transferable by delivery.'

According to Section 13 of the Negotiable Instruments Act, "a negotiable instrument means a *promissory note, bill of exchange* or *cheque* payable either to order or to bearer." "A negotiable instrument may be made payable to two or more payees jointly, or it may be made payable in the alternative to one of two, or one or some of several payees" [Section 13(2)].

The Act, thus, mentions three kinds of negotiable instruments, namely

[1]Throughout Part IV of this book (*i.e.*, Chapters 25-30), which deals with the Law of Negotiable Instruments, the references to Sections, unless otherwise specifically stated, are references to Sections of the Negotiable Instruments Act, 1881 as amended up-to-date. The word 'Act' wherever used means the Negotiable Instruments Act.

[2]The Negotiable Instruments Act, 1881, has been amended for more than a dozen times so far. The latest in the series is the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988.

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notes, bills and cheques and declares that to be negotiable they must be made payable in any of the following forms:

(a) **Payable to order.** A note, bill or cheque is payable to order which is expressed to be 'payable to a particular person of his order.' For example, *(i)* Pay *A*, *(ii)* Pay *A* or order, *(iii)* Pay to the order of *A*, *(iv)* Pay *A* and *B*, and *(v)* Pay *A* or *B* are various forms in which an instrument may be made payable to order. But it should not contain any words prohibiting transfer, *e.g*, 'Pay to *A* only' or 'Pay to *A* and none else' is not treated as 'payable to order' and therefore such a document shall not be treated as negotiable instrument because its negotiability has been restricted. It may be noted that documents containing express words prohibiting negotiability remain valid as a document (*i.e.*, as an agreement) but they are not negotiable instruments as they cannot be negotiated further. There is, however, an exception in favour of a cheque. A cheque crossed "Account Payee only" can still be negotiated further, of course, the banker is to take extra care like a bloodhound in that case.[3]

(b) **Payable to bearer.**'Payable to bearer' means 'payable to any person whosoever bears it.' A note, bill or cheque is payable to bearer which is expressed to be so payable or on which the only or last endorsement is an endorsement in blank. Thus, a note, bill or cheque in the form "Pay to *A* or bearer," or "Pay *A*, *B* or bearer," or "Pay bearer" is payable to bearer. Also, where an instrument is originally 'payable to order,' it may become 'payable to bearer' if endorsed in blank by the payee. For example, a cheque is payable to *A*. *A* endorses it merely by putting his signature on the back and delivers it to *B* with the intention of negotiating it (without making it payable to *B* or *B*'s order). In the hands of *B* the cheque is a bearer instrument.

Section 31 of the Reserve Bank of India Act. It is important to note that the above definition is subject to the provisions of Section 31 of the Reserve Bank of India Act, 1934, which as amended by the Amendment Act of 1946, provides as under:

1. No person in India other than the Reserve Bank or the Central Government can make or issue a promissory note 'payable to bearer.'

2. No person in India other than the Reserve Bank or the Central Government can draw or accept a bill of exchange 'payable to bearer on demand.'

3. A cheque 'payable to bearer on demand' can be drawn on a person's account with a banker.

The effect of the above provisions is that-(i) A promissory note cannot be *originally* made 'payable to bearer,' no matter whether it is payable on

[3]For details about *crossing of cheques*, refer to Chapter 30—"*Banker and Customer*."

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demand or after a certain time. It must be made 'payable to order' initially. However, on being endorsed in blank it can become 'payable to bearer' or 'payable to bearer on demand' subsequently and it shall be valid in that case.

(ii) A bill of exchange may be *originally* made 'payable to bearer' but it must be payable otherwise than on demand (say, payable three months after date) in that case. If it is 'payable on demand' then it must be made 'payable to order.' However, on being endorsed in blank subsequently, it can become 'payable to bearer on demand.'

(iii) A cheque drawn on a bank can be originally made 'payable to bearer on demand' and it shall be valid. In fact cheques are always payable on demand.

The object of the above provisions of the Reserve Bank of India Act is to prevent private persons from infringing the monopoly of the Reserve Bank and the Government of Note Issue in India. For, if individuals are allowed to issue instruments 'payable to bearer on demand,' then there may be some one so rich and well known person whose bills of exchange and promissory notes may be taken as currency notes. A currency note bears the words 'I promise to pay the bearer the sum of Rupees 10,50 or 100,' as the case may be. The general public is, therefore, prohibited to issue such notes or bills. Section 32 of the Reserve Bank of India Act, 1934, makes the issue of such bills or notes a criminal offence and declares them illegal and unenforceable at law. Accordingly, 'a promise to pay *A* or bearer' *or* 'a promise to pay the bearer' is not enforceable at law and the document containing such a promise is illegal and void.

More comprehensive definition. The definition given in Section 13 of the Negotiable Instruments Act does not set out the essential characteristics of a negotiable instrument. Possibly the most expressive and all-encompassing definition of negotiable instrument had been suggested by Thomas which is as follows:[4]

"A negotiable instrument is one which is, by a legally recognised custom of trade or by law, transferable by delivery or by endorsement and delivery in such circumstances that *(a)* the holder of it for the time being may sue on it in his own name and *(b)* the property in it passes, free from equities, to a *bonafide* transferee for value, notwithstanding any defect in the title of the transferor."

Characteristics of a Negotiable Instrument

An examination of the above definition reveals the following *essential characteristics* of negotiable instruments which make them different from an ordinary chattel:

[4]Thomas, *Commerce, Its Theory and Practice.*

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1. **Easy negotiability**. They are transferable from one person to another without any formality. In other words, the property (right of ownership) in these instruments passes by either endorsement and delivery (in case it is payable to order) or by delivery merely (in case it is payable to bearer), and no further evidence of transfer is needed.

2. **Transferee can sue in his own name without giving notice to the debtor.** A bill, note or a cheque represents a debt, *i.e.*, an "actionable claim"[3] and implies the right of the creditor to recover something from his debtor. The creditor can either recover this amount himself or can transfer his right to another person. In case he transfers his right, the transferee of a negotiable instrument is entitled to sue on the instrument in his own name in case of dishonour, without giving notice to the debtor of the fact that he has become holder. In case of transfer or assignment of an ordinary "actionable claim" (*i.e.*, a book debt evidenced by an entry by the creditor in his account book or *bahi*), under the Transfer of Property Act, notice to the debtor is necessary in order to make the transferee entitled to sue in his own name, otherwise he has always to join his transferor *i.e.*, the original creditor before he can recover his claim from the debtor.

3. **Better title to a bonafide transferee for value.** A *bonafide* transferee of a negotiable instrument for value (technically called as a *holder in due course*) gets the instrument 'free from all defects.' He is not affected by any defect of title of the transferor or any prior party. Thus, the general rule of the law of transfer applicable in the case of ordinary chattels that 'nobody can transfer a better title than that of his own' does not apply to negotiable instruments. A man may sell to another a stolen radio set but the true owner may claim back the radio set from the buyer even though he may have got it in good faith for consideration. The result would have been different if instead of the radio set a negotiable instrument, say, a bill of exchange made payable to bearer, had thus been transferred, in which case the buyer would have obtained a good title. It is relevant to state that such instruments which restrict transferability (although otherwise appearing as negotiable instruments) *i.e.*, bearing words like 'Pay *A* only', 'Pay to *A* and none else' *etc.*, are treated like ordinary chattels and not like negotiable instruments. Hence the transferee takes such instruments subject to all equities and his title shall not be better than that of the transferor.

4. **Presumptions.** Certain presumptions apply to all negotiable instruments. These presumptions shall be discussed later in this Chapter.

[3]An "actionable claim" is a right which can be enforced by action in a Court of law, *e.g.*, book debts. It is designated in English Law as "chose in action" by way of distinguishing such personal property from tangible chattels.

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Examples of Negotiable Instruments

The following instruments have been recognised as negotiable instruments by statute or by usage or custom: *(i)* Bills of exchange; *(ii)* Promissory notes; *(iii)* Cheques; *(iv)* Government promissory notes; *(v)* Treasury bills; *(vi)* Dividend warrants; *(vii)* Share warrants; *(viii)* Bearer debentures; *(ix)* Port Trust or Improvement Trust debentures; *(x)* Hundis; *(xi)* Railway bonds payable to bearer, etc.

Examples of Non-negotiable Instruments

These are *(i)* Money orders; *(ii)* Postal orders; *(iii)* Fixed deposit receipts; *(iv)* Share certificates; *(v)* Letters of credit.

Examples of Quasi-negotiable Instruments

There are some instruments called as document of title, *e.g.*, *(i)* bills of lading; *(ii)* dock warrants; *(iii)* railway receipts and *(iv)* wharfinger certificates, which, like a negotiable instrument, are capable of being transferred by endorsement and/or delivery, but the transferor of such documents cannot give to the holder any better title to the goods than he himself possesses. Such instruments are termed as 'quasi-negotiable instruments' and the provisions of the Negotiable Instruments Act do not apply to them.

Presumptions as to Negotiable Instruments

Sections 118 and 119 lay down the following presumptions in respect of negotiable instruments, unless the contrary is proved:

(a) that every negotiable instrument was made, drawn, accepted, indorsed or transferred *for consideration;*

(b) that every negotiable instrument bearing a date was made or drawn *on such date;*

(c) that every bill of exchange was *accepted within a reasonable time* after its date and before its maturity;

(d) that every *transfer* of a negotiable instrument was made before its maturity;

(e) that the *endorsements* appearing upon a negotiable instrument *were made in the order* in which they appear thereon;

(f) that a lost negotiable instrument was *duly stamped;*[6]

(g) that the holder of a negotiable instrument is a *holder in due course;* but this presumption would not arise where it is proved that the holder has obtained the instrument from its lawful owner, or from any person in lawful custody thereof, by means of an offence, fraud or for unlawful consideration

[6]No stamp duty is prescribed for cheques under the Indian Stamp Act.

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and in such a case the holder has to prove that he is a holder in due course;

(h) that the instrument was dishonoured, in case a suit upon a dishonoured instrument is filed with the court and the fact of 'protest' is proved.

The above presumptions are rebuttable by the defendant.

PROMISSORY NOTE

Definition

According to Section 4 "a promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument."

Before analysing the essentials of a promissory note as contained in this definition, the following facts are worth noting:

(i) A promissory note payable 'only to a particular person' is valid if it satisfies the requirements of the definition, but it shall not be a negotiable instrument within the meaning of the Negotiable Instruments Act as its transferability is restricted. To put it differently, it would appear from the above definition that negotiability is not essential to the validity of a promissory note as an instrument.

(ii) As observed earlier, under Section 31 of the Reserve Bank of India Act, 1934, no person in India except the Reserve Bank or the Central Government can make or issue a promissory note *payable to bearer.* Accordingly, a promissory note cannot be originally made 'payable to bearer.' Thus, the words 'or to the bearer of the instrument' included in the above definition have become redundant and ineffective. In fact these words ought to have been deleted after the passing of the Reserve Bank of India Act, 1934.

(iii) Bank notes (*i.e.*, promissory notes issued by a banker payable to bearer on demand) and currency notes (*i.e.*, promissory notes issued by the Reserve Bank of India or the Central Government payable to bearer on demand) are excluded from the definition of a promissory note because both of them are treated as money. The issue of bank notes, however, is now prohibited by the Reserve Bank of India Act. But Government promissory notes, which are issued by the Government for raising loans, are within the definition.

(iv) The person who makes the promise to pay is called the 'maker.' He is the debtor and must sign the document. The person to whom payment is to be made (*i.e.*, the creditor) is called the 'payee.'

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Essentials of a Promissory Note

From the definition given in the Act it follows that to be a valid promissory note, an instrument must fulfil the following essential requirements:

1. **It must be in writing.** A promissory note has to be in writing. An oral promise to pay does not become a promissory note. The writing may be on any paper, on any *bahi* or book. It may be in pencil or in ink and includes printing or typing. No particular form of words is necessary, even a promise contained in a letter will suffice, provided the other requirements of Section 4 are complied with. Of course the words used must import a clear undertaking to pay, but it is not necessary that the word 'promise' should be used (*Balmukund* vs *Munnalal*[7]).

The following is the usual form of a promissory note:

Rs 1,000 Delhi, 25 July 1993

Sixty days after date I promise to pay to Mr. J.N. Vaish or order the sum of rupees one thousand only with interest thereon at 12 per cent per annum for value received.

Revenue Stamp

Sd. Ram Kishore

ILLUSTRATIONS. A signs the instruments in the following terms:

(a) "I promise to pay *B* or order Rs 500"[8]

(b) "I acknowledge myself to be indebted to *B* in Rs 1,000 to be paid on demand, for value received."[9]

Both the above Instruments are valid promissory notes.

2. **It must contain a promise or undertaking to pay.** There must be a promise or an undertaking to pay. The undertaking to pay may be gathered either from express words or by necessary implication. A mere acknowledgement of indebtedness is not a promissory note, although it is valid as an agreement and may be sued upon as such.

ILLUSTRATIONS. *A* signs the instruments in the following terms:

(a) "Mr *B* I.O.U. (I owe you) Rs 1,000."[10]

(b) "I am liable to pay to *B* Rs 500."

(c) "I have taken from *B* Rs 2,000 and I am accountable to him for the same with interest."

[7]A.I.R. (1970), Punj. 516.
[8]Illus. *(a)* to Sec. 4.
[9]Illus. *(b)* to Sec. 4.
[10]Illus. *(c)* to Sec. 4.

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The above instruments are not promissory notes as there is no undertaking or promise to pay. There is only an acknowledgement of indebtedness.

Where, however, the acknowledgement of indebtendness contained in the document is in a defined sum of money *payable on demand,* there is a valid promissory note even though the words 'promise to pay' may not have been used. It is so because the phrase 'payable on demand' necessarily implies 'a promise to pay at once or immediately.'

ILLUSTRATION. Where *A* signs the instrument in the following terms: "I acknowledge myself to be indebted to *B* in Rs 1,000, *to be paid on demand,* for value received," there is a valid promissory note.[11]

3. **The promise to pay must be unconditional.** Certainty is very necessary in the commercial world. As such a promissory note must contain an unconditional promise to pay The promise to pay must not depend upon the happening of some uncertain event *i.e.*, a contingency or the fulfilment of a condition. It must be payable absolutely. If an instrument contains a conditional promise to pay, it is not a valid promissory note and will not become valid and negotiable even after the happening of the condition (*Hill* vs *Halford*[12]).

ILLUSTRATIONS. *A* signs the instruments in the following terms:

(a) "I promise to pay *B* Rs 500 seven days after may marriage with *C*."[13]

(b) "I promise to pay *B* Rs 500 on *D*'s death, provided *D* leaves me enough to pay that sum."[14]

(c) "I promise to pay *B* Rs 500 as soon as I can."

The above instruments are not valid promissory notes as the payment is made dependent upon the happening of an uncertain event which may never happen and as a result the sum may never become payable.

But a promise to pay is not conditional if the amount is made payable at a particular place or after a specified time or on the happening of an event which must happen, although the time of its happening may be uncertain (Sec. 5, Para 2). Thus, if *A* signs an instrument stating: "I promise to pay *B* Rs 500 seven days after *C's* death," the promissory note is valid because it is not considered to be conditional, for it is certain that *C* will die, though the exact time of his death is uncertain.

4. **It must be signed by the maker.** It is imperative that the promissory note should be duly authenticated by the 'signature' of the maker. 'Signature' means the writing or otherwise affixing a person's name or a mark to represent his name, by himself or by his authority with the intention of authenticating a document. The signature may be in any part of the instru-

[11]Illus. *(b)* to Sec. 4.
[12]2 B.P. 413.
[13]Illus. *(f)* to Sec. 4.
[14]Illus. *(g)* to Sec. 4.

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ment and need not necessarily be at the bottom. The intention to sign, however, must in all cases be proved. It may be in pencil or in ink. When the maker of a pro-note is illiterate, his thumb mark is sufficient. But facsimile impressions, whether affixed in printing or by perforation or in some other form, and impressions by a rubber stamp are not recognised as signatures unless the parties specifically agree to treat them as such.

5. **The maker must be a certain person.** The instrument itself must indicate with certainty who is the person or are the persons engaging himself or themselves to pay. In case a person signs in an assumed name, he is liable as a maker because a maker is taken as certain if from his description sufficient indication follows about his identity. Where there are two or more makers, they may bind themselves jointly or jointly and severally. But alternative promisors are not permitted in law because of the general rule that "where liability lies no ambiguity must lie," Thus a Note in the form "I Alok Kumar promise to pay" and signed by Alok Kumar *or* also Satish Chandra is a good Note as against Alok Kumar only.

6. **The payee must be certain.** Like the maker the payee of a pronote must also be certain on the face of the instrument. A note is valid even if the payee is misnamed or indicated by his official designation only (Sec. 5, para 4), provided he can be ascertained by evidence. It may be made payable to two or more payees jointly or it may be made payable in the alternative to one of two, or one or some of several payees [Sec, 13(2)]. Thus alternative payees are permissible in law. But it must be made payable to order originally. A note originally made payable to bearer is illegal and void as per Reserve Bank of India Act, 1934. Also, a note in favour of fictitious person is illegal and void, for it is teated as payable to bearer. A pro-note made payable to the maker himself is a *nullity,* the reason being the same person is both the promisor and the promisee.

7. **The sum payable must be certain.** For a valid promissory note it is also essential that the sum of money promised to be payable must be certain and definite. The amount payable must not be capable of contingent additions or substractions.

ILLUSTRATIONS. *A* signs instruments in the following terms:

(a) "I promise to pay *B* Rs 500 and all other sums which shall be due to him"[15]

(b) "I promise to pay *B* Rs 500, first deducting thereout any money which he may owe me."[16]

(c) "I promise to pay *B* Rs 500 and all fines according to rules."

(d) "I promise to pay *B* Rs 100 on or before 15 August 1993, and a similar sum monthly every succeeding month."

The above instruments are invalid as promissory notes because the exact amount to be paid by *A* is not certain.

[15]Illus. *(d)* to Sec. 4.

[16]Illus. *(e)* to Sec. 4.

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But, according to Section 5, para 3, the sum does not become indefinite merely because:

(i) there is a promise to pay the amount with interest, provided the rate of interest is stated;

(ii) the amount is to be paid at an indicated rate of exchange or according to the course of exchange; or

(iii) the amount is payable by instalments, even with a provision that on default being made in payment of an instalment, the balance unpaid shall become due.

9. **The amount payable must be in legal tender money of India.** A document containing a promise to pay a certain amount of foreign money or to deliver a certain quantity of goods is not a promissory note. Similarly, a promise to deliver paddy either in the alternative or in addition to money does not constitute a promissory note. Thus, an instrument signed by *A*, saying, "I promise to pay *B* Rs 500 and to deliver to him my black horse on 1st January next"[17] is not a valid promissory note.

10. **Other formalities**. Though it is usual and proper to state in a note the place where it is made and the date on which it is made but their omission will not render the instrument invalid. Even where the amount is made payable at a certain time after date, omission of date does not invalidate the instrument and the date of execution can be independently ascertained or proved. The words "value received" are also not an essential part of the form of a pro-note, because, as per Section 118, consideration is presumed until the contrary is proved. But a promissory note must be properly stamped as required by the Indian Stamp Act and each stamp must also be duly cancelled. The maker's signature with the date across the stamp cancels the stamp effectively. Although an unstamped or inadequately stamped promissory note is invalid, but the amount of loan can be recovered if proved otherwise.

BILL OF EXCHANGE

Definition

Section 5 of the Negotiable Instruments Act defines a bill of exchange as follows:

"A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument."

At the very outset the following two facts must be noted:

(i) Although a bill of exchange directing to pay 'only to a particular

[17]Illus. *(h)* to Sec. 4.

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person' is valid if it satisfies the requirements of the definition but it shall not be a negotiable instrument within the meaning of the Negotiable Instruments Act as its transferability is restricted.

(ii) Although a bill of exchange may be originally drawn 'payable to bearer' but in such a case it must be payable otherwise than on demand (say, three months after date). In other words, a bill cannot be drawn 'payable to bearer on demand.' If it is 'payable on demand' then it must be made 'payable to order' (Sec. 31, of the Reserve Bank of India Act).

Parties to a bill of exchange. There are three parties to a bill of exchange *viz., drawer, drawee* and *payee.* The person who makes the bill is called the 'drawer.' The person who is directed to pay is called the 'drawee.' The person to whom the payment is to be made is called the 'payee.' The drawer, or, if the bill is endorsed to the payee, the endorsee, who is in possession of the bill is called the 'holder.' The holder must present the bill to the drawee for his acceptance. When the drawee accepts the bill, by writing the words 'accepted' and then signing it, he is called the 'acceptor.'

It is not necessary, however, that three separate persons should answer to the description of drawer, drawee and payee. One person may fill any two of these positions. Thus, one may become 'drawer and payee' (when the bill is drawn "Pay to me or my order"), or 'drawee and payee' (when the bill is subsequently endorsed in favour of the drawee), or 'drawer and drawee' (when one draws a bill upon himself). In the last case, the holder may treat the instrument as a bill of exchange or as a promissory note. What is required is that the three parties *drawer, drawee* and *payee* must be pointed out in the bill with certainty.

Drawee in case of need. Sometimes the name of another person may be mentioned in a bill of exchange as the person who will accept the bill, if the original drawee does not accept it. Since another person so named is to be approached in case of need, he is known as "drawee in case of need." (Sec. 7)

Acceptor for honour. When a bill of exchange has been noted or protested for non-acceptance or for better security, and any person accepts it *supra protest* for honour of the drawer or of any one of the indorsers, such person is called an "acceptor for honour" (Sec. 7). Thus any person may voluntarily become a party to a bill as an "acceptor for honour."

Essentials of a Bill of Exchange

To be a valid bill of exchange an instrument must comply with the requirements of the definition given in Section 5, which are as follows:

1. It must be in *writing.*
2. It must contain an *order to pay.* A mere request to pay on account

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will not amount to an order. But an order may be expressed in polite language.

3. The order to pay must be *unconditional.*

4. It must be *signed by the drawer.*

5. *The drawer, drawee and payee must be certain.* A bill cannot be drawn on two or more drawees in the alternative because of the rule of law that "where liability lies, no ambiguity must lie." But a bill may be made payable in the alternative to one of two or more payees [Sec. 13).

6. The *sum payable must be certain.*

7. The bill must contain an order to pay *money only.*

8. It must comply with the formalities as regards date, consideration, stamps, etc.

It will be seen that the fundamental essentials of a bill enumerated above are more or less similar to that of a promissory note. As such the rules that apply to promissory notes in regard to those essentials are in general applicable to bills of exchange as well. (For details of these essentials see notes to promissory note.)

Special Benefits of Bill of Exchange

The special benefits of using bills of exchange in the world of commerce are as follows:

1. A bill of exchange is a double secured instrument. If the bill is dishonoured by the acceptor, the holder or the payee may look to the drawer of the bill for payment.

2. In case of immediate need of money a bill can be discounted with a bank by the payee.

3. Two separate trade debts can be discharged by a bill of exchange. Hence, where *A* buys goods on credit from *B* for Rs 1,000 to be paid three months after date and *B* buys goods on credit from *C* on similar terms for similar amount, an order by *B* to *A* to pay the sum of Rs 1,000 to *C* will discharge two separate trade debts.

Specimen of a Bill of Exchange

Rs 1,000 New Delhi, 15 August 1987

Three months after date pay to *C* or order the sum of rupees one thousand only, for value received

To

A

135 Sadar Bazar

Delhi

Accepted Sd/- A

Sd/-

Revenue Stamp *B*

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Distinction between a Pro-note and a Bill

The points of distinction between a promissory note and a bill of exchange are as follows:

1. **Number of parties.** In a promissory note there are two parties — the maker of the note and the payee. In a bill of exchange there are three parties— the drawer, the drawee and the payee.

2. **The maker of a note cannot be the payee.** In the case of a promissory note the maker cannot be the payee for the simple reason that the same person cannot be both the promisor and the promisee. But in a bill of exchange the drawer and the payee may be one and the same person as where a bill is drawn "Pay to me or my order."

3. **Promise and order.** In a promissory note there is a promise to make the payment whereas in a bill of exchange there is an order for making the payment.

4. **Acceptance.** A promissory note requires no acceptance as it is signed by the person who is liable to pay. The drawer of a bill of exchange is generally the creditor of the drawee and therefore it must be accepted by the drawee before it can be presented for payment.

5. **Nature of liability**. The liability of the maker of a pro-note is primary and absolute but the liability of a drawer of a bill of exchange is secondary and conditional. It is only when the acceptor does not honour the bill that the liability of the drawer arises as a surety. (Secs. 30 and 32)

6. **Maker's position**. The maker of a promissory note stands in immediate relation with the payee, while the maker or drawer of an accepted bill stands in immediate relation with the acceptor and not the payee (Explanation to Sec. 44).

The position of the maker of a pro-note also differs from the position of the acceptor of a bill. A promissory note must contain an unconditional promise to pay and therefore the maker, who himself is the originator of a note, cannot make it conditional. In the case of a bill of exchange although the drawer, who is the originator of a bill, has to make an unconditional order to pay but under Section 86 the acceptor may accept the bill conditionally.

7. **Payable to bearer.** A promissory note cannot be drawn 'payable to bearer,' while a bill of exchange can be so drawn provided it is not drawn 'payable to bearer on demand.'

8. **Notice of dishonour.** In case of dishonour of a bill of exchange, notice of dishonour must be given by the 'holder' to all prior parties who are liable to pay (including the drawer and endorsers), whereas in case of dishonour of a promissory note, no notice is necessary to the maker.

9. **Applicability of certain provisions.** The provisions relating to presentment for acceptance, acceptance, acceptance *supra protest* and drawing

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of bills in sets are applicable only to a bill of exchange, they are not applicable to a promissory note.

Bills in Sets

When a bill is drawn in sets of three, it is known as drawing the 'bill in sets.' Bills in sets are usually drawn when they are to be sent from one country to another. The three parts of a bill in set are sent by different mail routes in order to ensure the safe transmission of at least one part to the drawee and its acceptance by him as early as possible. Sections 132 and 133 provide the following rules for a bill in sets:

1. Bills of exchange may be drawn in sets or parts. All the parts together make a set and the whole set constitutes only one bill.
2. Each part of a bill in set should be numbered and must contain a provision that it shall continue payable only so long as the other parts remain unpaid.
3. The drawer must sign each part of the bill and should deliver all the parts. But only one part is required to be stamped and only one part is to be accepted by the drawee.
4. If payment is made on one of the parts of the bill, the whole bill is extinguished.
5. Where a person accepts or indorses different parts of the bill in favour of different persons and they go into the hands of different holders in due course, he and the subsequent indorsers of each part are liable on such part as if it were a separate bill.
6. When two or more parts of a set are negotiated to different holders in due course, then as between holders in due course he who first acquired title to his part is entitled to the other parts and the money represented by the bill.

Specimen of a Bill in a Set

First Part

No.1
Rs 5,000

New Delhi, 15 January 1993

Three months after sight of this first of exchange (second and third of the same tenor and date being unpaid) pay to A. K. Basu or order the sum of five thousand rupees for value received.

To
C.G Silcocks
London.

Revenue Stamp

Sd/- B.B. Lal

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Similarly second and third parts of the bill are drawn. The second part contains a reference to the first and third parts, and the third part contains a reference to the first and second parts.

Accommodation Bill

An accommodation bill is apparently quite similar to an ordinary trade bill of exchange. The special feature which distinguishes it from an ordinary bill is that such a bill is not supported by any consideration or a trading transaction. The drawer does not give any consideration to the drawee but instead it is drawn with an object of providing financial help either to the drawer or to both the drawer and the drawee. Thus the relationship between the drawer and the drawee is not that of a creditor and a debtor in the case of an accommodation bill. Actually it is a sort of mercantile credit where one person lends out his name on the bill so that the other person taking the bill can get the same discounted from the bank and get money for the same. Since such bills are drawn and accepted without any consideration with a view to accommodate or oblige friends, they are rightly termed as 'accommodation bills.'

ILLUSTRATION. *P* desires to have Rs 5,000 for three months and approaches *Q* for that purpose. *Q* has no funds in hand but has credit in the market. *Q* agrees to help *P*. It is arranged, therefore, that *P* will draw a bill on *Q* for Rs 5,000 payable after three months and *Q* will accept the bill. *P* can discount the bill with his bankers and get the money or can negotiate the bill in discharge of his debt. Before the maturity of the bill, *P* will provide *Q* with funds sufficient to meet it. Thus *P* is able to get the required funds for three months. Such a bill is called an accommodation bill.

The party accommodating (*i.e.*, *Q*) is called the 'accommodation party' and the party accommodated (*i.e. P*) is called the 'accommodated party.'

Sometimes a party may be accommodated by endorsing an existing bill with consideration. Such an endorser is called the 'backer' and the operation is called 'backing the bill'.

The Negotiable Instruments Act lays down the following rules regarding accommodation bill:

1. An accommodation bill creates no obligation of payment between the parties to the transaction. In other words, the accommodation party is not liable on the bill to the accommodated party on maturity date, if the bill is in the hands of the accommodated party because of subsequent indorsement in his favour, or if the bill has been paid by the accommodated party (*i.e.*, the drawer) on its dishonour by the acceptor (*i.e.*, the accommodation party), as the contract between them is not based on any consideration. (Sec. 43)

2. The accommodation party is liable on the bill to any subsequent 'holder for value,' even if such a holder knew at the time of taking the bill

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that it is an accommodation bill (Sec. 43). Of course the accommodation party is entitled to recover from the accommodated party whatever he pays on the bill.

3. An accommodation bill can be negotiated after maturity (*i.e.*, when it becomes over due), with all benefits of a 'holder in due course' to the transferee *(i.e.*, the transferee acquiring a better title than the transferor) (Sec. 59). (The transferee of an over due ordinary bill of exchange gets no better title than his transferor as he cannot be a 'holder in due course.' Section 9 provides that a 'holder in due course' should acquire the instrument before maturity).

4. Non-presentation of an accommodation bill to the acceptor for payment does not discharge the drawer. [Section 76 *(d)* provides that presentation is not necessary when drawer could not suffer damage.] It is an exception to the general rule contained in Section 64 whereby a bill must be presented for payment to the acceptor by the holder otherwise other parties thereto are not liable thereon to such a holder.

5. When an accommodation bill is dishonoured, failure to give notice of dishonour does not discharge the liability of prior parties, as it does in the case of an ordinary bill [Sec. 98 *(c)*].

Fictitious Bill

When in a bill of exchange the names of both the drawer and the payee are fictitious, the bill is said to be a fictitious bill. Such a bill is drawn in a fictitious name and is made payable to the drawer's order and as such the names of both the drawer and the payee are said to be of a fictitious person. A fictitious person is one who has no existence *i.e.*, who is imaginary. If a real existing person's name is forged as drawer and payee, then the bill is a 'forged bill', which is a nullity and confers no title even to a holder in due course. In a forged instrument there is complete absence of title as distinct from defect of title.

A fictitious bill even if accepted by a genuine person is not a good bill and cannot be enforced at law. However, such a bill, if accepted by a genuine person, becomes a good bill in the hands of a holder in due course provided he can show that the first indorsement on the bill and the signature of the supposed drawer (being the holder as well) are in the same handwriting, and the acceptor is liable on the bill to him (Sec. 42).

Documentary Bill

When documents relating to the goods represented by the bill, *e.g.*, bill of lading or railway receipt, invoice, marine insurance policy, *etc.*, are attached to a bill, the bill is called a documentary bill. Such documents are delivered to the buyer only on acceptance or payment of the bill. Such bills

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are usually used in foreign trade. In inland trade generally "clean bills" are used with which no other documents are attached.

CHEQUE

Definition

Section 6 defines a cheque as follows:

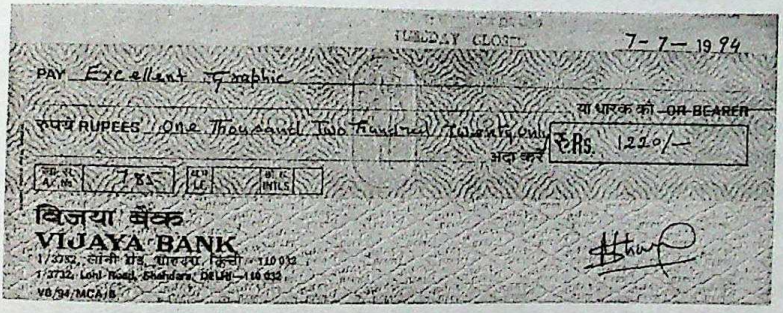
"A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand."

Thus, a cheque is a bill of exchange with two distinctive features, namely:

(i) it is always drawn on a bank, and

(ii) it is always payable on demand.

Specimen of a Cheque



Distinction between a Cheque and a Bill of Exchange

Although a cheque, being a species of a bill of exchange, must satisfy almost all the essentials of a bill, *e.g.*, signed by the drawer, containing an unconditional order, to pay a certain sum of money, to the order of a person or the bearer, *etc.*, yet there are few points of difference between the two, namely:

1. A cheque is always drawn on a banker, while a bill may be drawn on any person, including a banker.

2. A cheque can only be drawn payable on demand, whereas a bill may be drawn payable on demand or on the expiry of a certain period after date or sight.

3. A cheque drawn 'payable to bearer on demand' is valid but a bill drawn 'payable to bearer on demand' is absolutely void and illegal (though a bill can be made payable to the bearer after a certain time) (Sec. 31, The Reserve Bank of India Act).

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4. A cheque does not require any acceptance by the drawee before payment can be demanded. But a bill requires acceptance by the drawee before he can be made liable upon it.

5. A cheque does not require any stamp, whereas a bill of exchange must be properly stamped.

6. Three days of grace are allowed while calculating the maturity date in the case of 'time bills' (*i.e.*, bills drawn payable after the expiry of a certain period). Since a cheque is always payable on demand, there is no question of allowing any days of grace.

7. Unlike cheques, a bill of exchange cannot be crossed.

8. Unlike cheques, the payment of a bill cannot be countermanded by the drawer.

9. Unlike bills, there is no system of Noting or Protest in the case of a cheque.

10. The drawer of a bill is discharged from liability, if it is not duly presented for payment, but the drawer of a cheque will not be discharged by delay of the holder in presenting it for payment, unless through the delay, the drawer has been injured, *e.g.*, by the failure of the bank the drawer has lost the money which would have otherwise discharged the amount of the cheque. However, where the drawer is so discharged, the payee may rank as creditor of the bank for the amount of the cheque. (Sec. 84)

Bank Draft

A bank draft is an order issued by one bank on another bank or on its own branch (usually drawn on its own branch) instructing the latter to pay a specified sum of money to a specified person or his order. It is a negotiable instrument[18] and is very much like a cheque, with the following distinctions:

(a) It can be drawn only by a bank on another bank or on its another branch and not by an individual as in the case of a cheque.

(b) It cannot so easily be countermanded as a cheque.

(c) It cannot be made payable to bearer.

HUNDIS

Hundis are negotiable instruments written in Hindustani language. Sometimes they are in the form of promissory notes but usually they are like bills of exchange in form and substance. The provisions of the Negotiable Instruments Act apply to Hundis unless there is a local usage to

[18] *State Bank of India* vs *Jyoti Ranjan Majumdar*, A.I.R. (1970) Cal. 503.

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the contrary. They are quite popular among the Indian Merchants from very old days.

Type of Hundis

The more popular types of hundis are as follows:

1. **Darshani hundi**. It is one payable at sight like a 'demand bill.' It must be presented for payment within a reasonable time of its receipt by the holder (*Gohra Mal* vs *Hari Singh*[19]). If loss is caused to the drawer by delay in presentment it falls on the holder.

2. **Miadi or Muddati hundi.** It is one payable after a specified period of time like a 'time bill.'

3. **Shah jog hundi**. This is a hundi made payable by the drawer only to a Shah. A Shah means a respectable person of worth and substance in the Bazar. It may be Darshani or Miadi. It may be transferred from one person to another by mere delivery, but it is payable only to a respectable person. If at the time of payment the hundi reaches the hands of a person of straw, the drawee would be within his right to refuse to honour the hundi. If the drawee makes payment of the hundi to a person other than a Shah he will not be entitled to recover from the drawer the money he pays to the holder. Thus, the drawee must make sure that he makes payment on a *Shah jog hundi* only to a Shah.

4. **Nam jog hundi.** Where a hundi is made payable to or to the order of specified person it is called a *nam jog hundi.* Such a hundi can be indorsed like a bill of exchange payable to order.

5. **Jokhmi hundi**. The term 'Jokhmi' means 'against risk.' A jokhmi hundi therefore is a combination of bill of exchange and insurance policy. Such a hundi implies a condition that the money shall be payable by the drawee only in the event of the safe arrival of the goods against which the hundi is drawn. The drawer of the hundi (*i.e.*, the consignor) discounts the hundi with the insurer, and thereby gets the sale price, less charges of the insurer, immediately. If the goods are lost in transit the insurer, cannot claim payment of the hundi from the drawee (*i.e.*, the consignee). Thus, if the goods arrive safely such a hundi works like a bill of exchange and if the goods are lost in transit such a hundi works like an insurance policy and protects the interests of the consignor and the consignee.

Certain general terms. There are certain terms which can be used in all types of hundis. Hundis *payable to the order* are known as '*Firman Jog*' hundis and hundis *payable to the bearer* are known as '*Dhani jog*' hundis. A hundi when paid and cancelled is called a '*Khokha.*' The duplicate of a hundi, when the original is lost, is called '*Peth.*' The duplicate of a duplicate hundi is called '*Perpeth.*'

[19] 5 LC 745.

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Inland and Foreign Instruments

A promissory note, bill of exchange or cheque which is *(i)* drawn or made in India and also made payable in India, or *(ii)* drawn or made in India upon any person resident in India, although it may be made payable in a foreign country, is deemed to be an *inland instrument.* (Sec. 11)

Since a promissory note is not drawn on any person, an inland promissory note, therefore, is one which is both made and payable in India.

Thus, the following are the examples of *inland instruments:*

(a) A promissory note made in Madras and payable in Delhi.

(b) A bill of exchange drawn in Delhi and made payable in Bombay (although the drawee may be residing outside India).

(c) A bill of exchange drawn in Kanpur on a person resident in Calcutta (although it may be made payable in London).

An instrument, which is not an inland instrument, is deemed to be a *foreign instrument* (Sec. 12). The following are the examples of *foreign instruments:*

(i) A promissory note made in India but made payable in Germany.

(ii) A bill of exchange drawn in India, *on a person residing outside India,* and made payable outside India.

(iii) A bill *drawn outside India* and made payable in India.

(iv) A bill *drawn outside India,* on a person residing in India.

Time and Demand Instruments

An instrument payable after a fixed time (say, after three months) or on a specified date (say, on 25 August 1993) is termed as a '*time instrument.*' An instrument payable after happening of an event which is certain to happen, *e.g.*, death, though the time of its happening may be uncertain, is also called a *time instrument.* In the case of *time instruments* the period of limitation begins to run from maturity date. It may be noted that there can be a 'time bill' or a 'time note' but not a 'time cheque,' the reason being that a cheque cannot be expressed to be payable otherwise than on demand.

An instrument payable *on demand* or *at sight (i.e.*, on presentation in case of a cheque or a promissory note, and on acceptance in case of a bill of exchange) is termed as a 'demand instrument.' Again, a promissory note or a bill of exchange in which no time for payment is specified is also a *demand instrument* (Sec. 19). In case of *demand instruments* the period of limitation begins to run from the date of their execution except where they are made payable 'at sight' in which case the period of limitation commences from the date of presentation.

Ambiguous Instruments

An instrument, which in form is such that it may either be treated as

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a bill of exchange or as a promissory note, is an *ambiguous instrument.* In such a case, the holder may either treat it as a bill of exchange or a promissory note, but once he has made his choice the instrument shall henceforth be treated accordingly. (Sec. 17)

The following are the examples of ambiguous instruments:

(a) Where in a bill the drawer and the drawee are the same person. Thus, where a bill is drawn by an agent, acting within the scope of his authority, upon his principal, the holder may, at his option, treat it as a note or a bill because the drawer and the drawee are the same person in the eye of law. But where drawer and payee are the same, *e.g.*, where a bill is drawn payable to the drawer's order, it is not an ambiguous instrument and is a valid bill of exchange.

(b) Where in a bill the drawee is a fictitious person or a person not having the capacity to contract. Thus, where *P* draws a bill on *Q* and negotiates it away, and *Q* is a fictitious or a minor drawee, the holder may treat the bill as a note made by *P*.

Inchoate Instruments

An incomplete or blank negotiable instrument properly stamped and signed is termed as an '*inchoate instrument.*' Section 20 deals with inchoate stamped instruments and provides that "where one person signs and delivers to another a paper stamped in accordance with the law relating to negotiable instruments, either wholly blank or having written thereon an incomplete negotiable instrument, he thereby gives *prima facie* authority to the holder thereof to make or complete, as the case may be, upon it a negotiable instrument, for any amount specified therein and not exceeding the amount covered by the stamp. The person so signing shall be liable upon such instrument, in the capacity in which he signed the same, to any holder in due course for such amount. But a person other than a holder in due course cannot recover from the person delivering the instrument anything in excess of the amount intended by him to be paid thereunder."

It is to be emphasised that *delivery* of a *stamped paper* to the *holder* is necessary for the application of this Section, otherwise the maker or acceptor will not be liable even to a subsequent holder in due course. Where, for example, a person signed a blank acceptance and kept it in his drawer, and some person stole it and filled it up for Rs 1,500 and negotiated it to an innocent person for value, it was held that the signer to the blank acceptance was not liable to the holder in due course because he never delivered the instrument intending it to be used as a negotiable instrument (*Baxendale* vs *Bennett*[20]).

[20](1878), 3 Q.B.D. 525.

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It is also important to note that although the Section makes the person signing and delivering the inchoate instrument liable to a 'holder' as well as to a 'holder in due course,' but there is a difference in their respective rights. A 'holder' can recover only what the signer intended to be paid under the instrument, while a 'holder in due course' can recover the whole amount made payable by the instrument provided that it is covered by the stamp, even though the amount authorised was smaller.

ILLUSTRATION. *P* owes *Q* some money on account of credit purchases made by him. *P* gives a promissory note, after affixing 20 paise stamp and signing, leaving the amount blank to *Q* authorising him to fill it up in accordance with the account. *Q* fills Rs 450 while actual amount due is Rs 300 only. *Q* cannot recover more than Rs 300. But if *Q* transfers it to *R*, a holder in due course, *R* can recover Rs 450, the full amount, from *P*. If, however, the amount filled in by *Q* is Rs 1,200, *R* cannot recover it, for the amount is not covered by the stamp.

Escrow

When a negotiable instrument is endorsed and delivered conditionally or for a special purpose only, *e.g.*, as collateral security or for safe custody, and not for the purpose of transferring absolutely property therein, it is called an 'escrow.' In this case the property in the instrument does not pass to the endorsee, and he is merely a bailee with limited title and power of negotiating it. This, however, does not affect the rights of a holder in due course.

Maturity of Negotiable Instruments

'Maturity' means the date on which the payment of an instrument falls due. An instrument payable on demand or at sight such as a cheque becomes payable immediately on the date of its execution and there is no question of its maturity. Its payment falls due at once on the date of its issue. The question of maturity, therefore, arises only in the case of a promissory note or a bill of exchange which is expressed to be payable otherwise than on demand.

Every promissory note or bill of exchange expressed to be payable on a specified day, or at a certain period after date or after sight, or at a certain period after the happening of an event which is certain to happen is at maturity on the third day after the day on which it is expressed to be payable (Sec. 22). A time bill or note is as such entitled to *three days of grace* and matures or falls due on the last day of grace (and not on the date on which it is expressed to be payable). For example, a bill of exchange drawn on 1st January, if expressed payable three months after date, is at maturity on 4th April. Such a bill or note must be presented for payment only on the last day of grace, and if dishonoured, the suit can be filed on the next day after maturity. Any presentment for payment earlier to the

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third day of grace is invalid, even if the word 'punctually' is added to a fixed date.

Rules for calculating maturity. Sections 23 to 25 lay down the following rules for calculating the maturity of a time bill or note:

1. If it is made payable *a stated number of months* after date or after sight, or after a certain event, it matures (or becomes payable) three days after the corresponding date of the month after the stated number of months.

ILLUSTRATION. A negotiable instrument, dated 30th August 1977, is made payable three months after date. The instrument is at maturity on the 3rd December 1977. [See Illustration *(b)* to Section 23.]

2. If the month in which the period would terminate has no corresponding date, the period shall be held to terminate on the last day of such month.

ILLUSTRATIONS. *(a)* A negotiable instrument dated 30th January 1977, is made payable at one month after date. The instrument is at maturity on the third day after the 28th February 1977 (*i.e*, 3rd March 1977). [Sec Illustration *(a)* to Section 23.]

(b) A promissory note or bill of exchange, dated 31st August 1977, is made payable three months after date. The instrument is at maturity on the 3rd December 1977. [Sec Illustration *(c)* to Section 23.]

3. If it is made payable *a certain number of days* after date or after sight, or after a certain event, the maturity is calculated by excluding the day on which the instrument is drawn or presented for acceptance or sight or on which the event happens. Note that only one day is to be excluded.

ILLUSTRATIONS. *(a)* A bill of exchange dated 1st March, is made payable 20 days after date. The period of 20 days will be counted from 2nd March, and the bill will be at maturity on 24th March.

(b) A bill of exchange, dated 1st January, and payable 20 days after sight, is presented for acceptance on the 5th January. The bill shall mature on 28th January.

4. If the date on which a bill or note is at maturity is a public holiday, the instrument shall be deemed to be due on the next preceding business day. The expression 'public holiday' includes Sundays and any other day declared by the Central Government, by notification in the Official Gazette, to be a public holiday. Thus, if the maturity of an instrument falls on Sunday, it shall be deemed to be due on Saturday. If the maturity falls on an emergency holiday, the instrument shall be deemed to be due on the next succeeding business day.

5. If an instrument is payable by instalments, three days of grace are to be allowed on each instalment (Sec. 67).

Payment in Due Course

The payment of the amount due under a negotiable instrument must amount to 'payment in due course' in order to operate as a valid discharge of the instrument against the holder. Section 10 provides that in order to

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constitute a payment of a negotiable instrument as a 'payment in due course,' the following conditions must be fulfilled:

1. *The payment must be in accordance with the apparent tenor of the instrument.* It should be made at or after maturity. A payment before maturity is not a payment in due course so as to discharge the instrument. Thus if a bill of exchange is paid before the last day of grace and is subsequently indorsed over, it is valid in the hands of a holder in due course and the acceptor will be liable to pay again on the instrument. Similarly, if the banker makes payment of a post dated cheque before the date mentioned therein, he acts against the apparent tenor of the instrument *i.e.*, against the true intentions of the drawer and hence the payment will not be treated as payment in due course.

2. *The payment must be made in good faith and without negligence.* It must be honestly made in the *bonafide* belief that the person demanding payment is legally entitled to it. The payer must not be guilty of any negligence in making the payment. If there are suspicious circumstances and the payer fails to make necessary inquiry which may reveal the defects, the payment is not a payment in due course. Thus if a specially endorsed bill of exchange is paid without inquiry as to the payee or if a cheque with forged signature of the drawer is paid, it, will amount to negligence on the part of the payer and the payment will not be treated as payment in due course.

3. *The payment must be made to a person in possession of the instrument* under circumstances which do not arouse suspicion about his title to possess the instrument and to receive payment of the amount therein mentioned. A payment cannot be a payment in due course if it is made without requiring production of the instrument and, therefore, the payer must insist on seeing the instrument before making the payment and must obtain the instrument on payment.

4. *The payment must be made in money only,* unless the holder agrees to accept payment in any other medium or by cheque or draft.

To sum up, 'payment in due course' implies payment *(i)* according to the apparent tenor of the instrument at or after maturity *(ii)* in good faith and without negligence *(iii)* in money (or by cheque if acceptable to the holder) *(iv)* to a person who is legally entitled to the instrument and is in possession of the same.

Payment of Interest

The Negotiable Instruments Act lays down the following provisions regarding the payment of interest:

1. *When rate specified.* When interest at a specified rate is expressly made payable on a promissory note or bill of exchange, interest shall be

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calculated at the rate specified, on the amount of the principal money due thereon, from the date of the instrument, until tender or realisation of such amount, or until such date after the institution of a suit to recover such amount as the Court directs (Sec. 79).

2. *When no rate specified.* When no rate of interest is specified in the instrument, or when no mention is made of interest at all,[21] interest on the amount due thereon shall, notwithstanding any oral agreement relating to interest between any parties to the instrument, be calculated at the rate of *eighteen per cent*[22] *per annum,* from the date at which the same ought to have been paid by the party charged, until tender or realisation of the amount due there on, or until such date after the institution of a suit to recover such amount as the Court directs (Sec. 80).

3. When the party charged is the indorser of an instrument dishonoured by non-payment, he is liable to pay interest only from the time that he receives notice of the dishonour (Explanation to Section 80).

TEST QUESTIONS

1. Define the term 'negotiable instrument.' What are its essential characteristics?

2. Distinguish between negotiable, non-negotiable and quasi-negotiable instruments, giving examples. What are the presumptions as to negotiable instruments?

3. Define a promissory note. What are its essential elements?

4. What is a bill of exchange? What are its essential elements? How does it differ from a promissory note?

5. Define a cheque. How does it differ from a bill of exchange?

6. Explain the distinguishing features of Promissory Notes, Bills of Exchange and Cheques.

7. What is a hundi? State the more popular types of hundis used in India.

8. Define the term 'maturity'. State the rules determining the maturity of negotiable instruments.

9. When is a payment on a negotiable instrument said to be a "payment in due course"? What are the rules relating to payment of interest on negotiable instruments?

10. Explain the following: *(a)* Bill in sets, *(b)* Accommodation bill, *(c)* Fictitious bill, *(d)* Ambiguous instruments, *(e)* Inchoate instruments, *(f)* Bank draft, and *(g)* Inland instruments.

[21] *Best* vs *Haji Mohammad,* 23 Mad. 18.

[22] Subs. for the words "six per cent" by the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988, *w.e.f.* 1-4-1989.

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PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. A bill is drawn payable at F-10 DDA flats, Janakpuri, but does not contain the name of the drawee. *W*, who resides at the said flat, accepts the bill. Is it a valid bill?

[**Hint**. Yes, it is a valid bill and *W* is liable thereon. The drawee may be named or otherwise indicated in the bill with reasonable certainty. In the instant case the description of the place of residence indicates the name of the drawee, and *W*, by his acceptance, acknowledges that he is the person to whom the bill is directed (*Gray* vs *Milner*, 1819, 2 Taunt 739).]

2. *X* draws a bill on *Y* and negotiates it to *Z*. *Y* is a fictitious person. Can *Z* treat it as a promissory note made by *X*?

[**Hint**. Yes, *Z* can treat the instrument as a promissory note. Where in a bill the drawee is a fictitious person, it is an ambiguous instrument and the holder is entitled to treat the bill as note.]

3. *P* signs his name on a blank but stamped instrument and gives the paper to *Q* with authority to fill it up as a promissory note for Rs 400 only. But *Q* fraudulently fills the paper for Rs 1,000, the stamp put upon it being sufficient to cover this amount. He then hands it to *R* for Rs 1,000 who takes it in good faith for value. Can *R* recover the whole amount?

[**Hint.** Yes, *R* can recover Rs 1,000 from *P*. Section 20 lays down that in the case of an inchoate instrument a holder in due course can recover the whole amount made payable by the instrument provided it is covered by the stamp, even though the amount authorised was smaller.]

4. A bill of exchange is payable to Hari Mohan or order. At maturity another person of the same name wrongfully gets possession of the bill and presents it to the acceptor for payment. After making due inquiries and being satisfied that the presenter is Hari Mohan, the acceptor makes payment on it. Is the acceptor discharged?

[**Hint.** Yes, the acceptor is discharged. When the presenter is in possession of the instrument and the acceptor pays it to him in good faith after due inquiry as to his identity, it is a payment in due course and the acceptor is discharged.]

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Chapter 26

Parties to Negotiable Instruments

Holder

The 'holder' of a negotiable instrument means any person entitled to the possession of the instrument in his own name and to receive or recover the amount due thereon from the parties liable thereto (Sec. 8). Thus, in order to be called a 'holder' a person must satisfy the following two conditions:

1. *He must be entitled to the possession of the instrument in his own name.* Actual possession of the instrument is not essential. What is required is a right to possession under some legal or valid title. He should be a '*de jure* holder' and not necessarily a '*de facto* holder.' It means that the person must be named in the instrument as the payee or the indorsee, or he must be the bearer thereof, if it is a bearer instrument. However, the heir of a deceased holder or any other person becoming entitled by operation of law is a holder although he is not the payee or indorsee or bearer thereof.

If a person is in possession of a negotiable instrument without having a right to possess the same he cannot be called the holder. Thus, a thief, or a finder on the road, or an indorsee under a forged indorsement, although may be having the possession of the instrument, cannot be called its holder because he does not acquire legal title thereto and hence is not entitled in his own name to the possession thereof. Similarly, a beneficial owner claiming through a 'benamidar' in whose favour the instrument had been made or drawn is not a holder because he is not entitled to the possession in his own name and cannot by himself maintain an action on the instrument (*Subba Narayana* vs *Ramaswami*[1]).

2. *He must be entitled to receive or recover the amount due thereon from the parties liable thereto.* In order to be called a holder, besides being entitled to the possession of the instrument in his own name, the person must also have the right to receive or recover the amount of the instrument and give a valid discharge to the payer. Thus, one may be the bearer or the payee or indorsee of an instrument but he may not be called a holder if he

[1](1907), 30 Mad. 88 (F.B.).

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is prohibited by a Court order from receiving the amount due on the instrument.

It may, thus, be concluded that both the above conditions must be satisfied by a person to be called a holder. For instance, where an instrument payable to order is, without endorsement, entrusted by the payee to his agent, the agent does not become the holder of it, although he may receive its payment, because he has no right to sue on the instrument in his own name.

The holder of a negotiable instrument is a very important party to the instrument as such. It is he alone who can sue upon a negotiable instrument, can negotiate it (with certain exceptions) and can give a valid discharge for it.

Holder in Due Course

The 'holder in due course' means any person who for consideration became the possessor of a negotiable instrument if payable to bearer, or the payee or indorsee thereof if payable to order, before the amount mentioned in it became payable, and without sufficient cause to believe that any defect existed in the title of the person from whom he derived his title (Sec. 9). Thus, in order to be called a 'holder in due course' a person must possess the following qualifications:

1. *He must be a 'holder,' i.e.*, he must be entitled to the possession of the instrument in his own name under a legal title and to recover the amount thereof from the parties liable thereto.

2. *He must be a holder for valuable consideration, i.e.*, there must be some consideration to which law attaches value. The consideration, however, need not be adequate. A donee, who acquires title to the instrument by way of gift, is not a holder in due course for want of consideration, although he is a holder. The consideration must also be lawful. Thus, a debt incurred in gambling is not valid or lawful consideration, and a person who acquires a bill or note in consideration of such a debt is not a holder in due course.

3. *He must have become the holder of the negotiable instrument before its maturity.* The holder who acquires a negotiable instrument after maturity cannot be a holder in due course. But an accommodation bill can be negotiated after maturity with all benefits of a holder in due course to the transferee (Sec. 59). In case of instruments payable on demand, *e.g.*, a cheque, he must have taken the instrument within a reasonable time of its issue. After the lapse of reasonable length of time the cheque becomes over due and any one who takes an over due cheque cannot be a holder in due course.

4. *He must take the negotiable instrument complete and regular on the*

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face of it. It is the duty of every person who takes a negotiable instrument to examine its form and contents thoroughly, for if it contains any material alteration which has not been confirmed by the drawer through his signature, or if it is incomplete, say, drawer's name is not there or it is not properly stamped, he will not become a holder in due course.

5. *He must have become holder in good faith* without having sufficient cause to believe that any defect existed in the title of the transferor. This is the most important condition to be satisfied. He must exercise great care and take all necessary precautions in finding out if the transferor's title was defective. Moreover, he must take the instrument without any negligence on his part. If there is something to arouse a suspicion and he takes the negotiable instrument without making proper inquiries he cannot be said to be acting in good faith and cannot be called a holder in due course. For example, when he takes a bill which has been torn and the pieces pasted together, at least if the tears appear to show an intention to cancel it, without inquiry, he is not a holder in due course.

Privileges of a Holder in Due Course

A holder in due course enjoys the following privileges under the Negotiable Instruments Act:

1. **He gets a better title than that of the transferor.** One who is a 'holder' only gets no better title than that of his transferor but a holder in due course is in a privileged position in that he gets a better title than that of the transferor and the defences on the part of a person liable that the instrument has been lost, or has been obtained from the holder thereof by means of an offence or fraud or for an unlawful consideration cannot be pleaded against a holder in due course (Sec. 58). For example, if *P* obtains an instrument payable to bearer by theft or fraud, or for an unlawful consideration, he cannot sue on it. But if *P* transfers the instrument (being a bearer one) to *R* under circumstances (for value in good faith) which make *R* a holder in due course, *R* can sue on the instrument. The party liable to pay can take, as against *P*, the defence of theft or fraud, but as against *R* he will not be allowed to take such a defence.

Further, not only the holder in due course himself gets a good title free from all defects but also serves as a channel to protect all subsequent holders. Once an instrument passes through the hands of a holder in due course it is purged of all defects. Section 53 states that "a holder of a negotiable instrument who derives title from a holder in due course has the rights thereon of that holder in due course." Thus, anybody who takes a negotiable instrument from a holder in due course can recover the amount from all prior parties, although he had knowledge of the prior defects *e.g.*, no consideration was paid by some of the prior parties or some one of them

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was a thief. It is important to note that a *forged instrument,* even if it passes through the hands of a holder in due course, cannot be cured of its defect because there is no *defect* of title but there is *complete absence* of title.

2. **Privilege in case of inchoate stamped instruments** (Sec. 20). In the case of inchoate stamped instrument, if the holder or original payee fills more amount than that was authorised, he cannot enforce the instrument for the whole amount (only actual authorised amount can be recovered). If such an instrument is transferred to a holder in due course, he can claim the whole of the amount so entered provided that the amount is covered by the stamp affixed thereon. Thus, the defence that the amount filled by the holder was in excess of the authority given cannot be taken against a holder in due course.

3. **Liability of prior parties.** All prior parties to a negotiable instrument (*i.e.*, its maker or drawer, acceptor and intervening indorsers) continue to remain liable to a holder in due course both jointly and severally (*i.e.,* he can hold any or all prior parties liable) until the instrument is duly satisfied (Sec. 36). Whereas, only *preceding party* is liable to a *succeeding party,* if the succeeding party is only a holder.

4. **Privilege in case of fictitious bills** (Sec. 42). When a bill of exchange is drawn in a fictitious name and is made payable to the drawer's order (*i.e.*, where both drawer and payee of a bill are fictitious persons), the bill is said to be a fictitious bill. Such a bill is not a good bill and cannot be enforced at law. But the acceptor of such a bill is liable to a holder in due course provided the latter can show that the first indorsement on the bill and the signature of the supposed drawer are in the same handwriting.

5. **Privilege when an instrument delivered conditionally is negotiated.** When a negotiable instrument is endorsed or delivered conditionally or for a special purpose only, *e.g.*, as collateral security or for safe custody, and not with the idea of transferring absolutely property therein, the property in the instrument does not pass to the indorsee, and he is merely a bailee with limited title and power of negotiating it. This, however, does not affect the rights of a holder in due course, *i.e.*, if such an instrument is negotiated to a holder in due course, the parties liable on the instrument cannot escape liability (Sections 46 and 47). For example, if I give a cheque to a shopkeeper with the condition that he should not encash the cheque till he supplies me the goods, anybody encashing the cheque prior to fulfilling the condition is liable to return the money except the holder in due course.

6. **Estoppel against denying original validity of instrument** (Sec. 120). The plea of original invalidity of the instrument; *e.g.*, that no consideration actually passed between the maker and the payee of a promissory note; cannot be put forth against the holder in due course by the drawer of a bill of exchange or cheque, or by the maker of a promissory note or by

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an acceptor of a bill for the honour of the drawer. However, the aforestated parties are not precluded from challenging the validity of the instrument on the ground that at the time of making the instrument he was a minor or his signature had been forged or the instrument is otherwise void *ab-initio*, *e.g.*, where a promissory note is made 'payable to bearer' it is void and illegal as per the Reserve Bank of India Act.

7. **Estoppel against denying capacity of payee to indorse** (Sec. 121). No maker of a note and no acceptor of a bill payable to order shall, in a suit thereon by a holder in due course, be permitted to deny the payee's capacity, at the date of the note or the bill, to indorse the same. The payee must be competent to indorse an instrument otherwise the indorsee does not become the holder thereof entitled to enforce payment in his own name. As per section 26 a minor or insane is competent to indorse. An insolvent, however, is not competent to indorse. By virtue of Section 121, a holder in due course can claim payment in his own name despite the payee's incapacity (being an insolvent) to indorse the instrument.

Capacity of Parties

"Every person capable of contracting, according to the law to which he is subject, may bind himself and be bound by the making, drawing, acceptance, indorsement, delivery and negotiation of a promissory note, bill of exchange or cheque" (Sec. 26). This Section thus declares that capacity to incur liability on negotiable instruments is co-extensive with the capacity to contract.

While studying the 'capacity of parties' to enter into a contract in Chapter 4, we have seen that if a party is not competent to contract (say, if he is a minor), the agreement is absolutely void and inoperative as against him but he can derive benefit under it. Thus, a person incompetent to contract cannot make himself liable as a party to negotiable instrument, but he may make the other parties competent to contract liable, because he can be a promisee or payee as per the Indian Contract Act. It follows, therefore, that if some of the parties to negotiable instrument are not capable of contracting, the instrument is void only as against such parties and the other competent parties remain bound under it. If, however, all the parties are incapable to contract, then the negotiable instrument is a nullity and does not have any legal value whatsoever.

The different cases of incapacity to incur liability as a party to negotiable instrument are discussed below:

Minor. Section 26 declares that a minor may draw, indorse, deliver and negotiate a negotiable instrument so as to bind all parties except himself. Accordingly, a minor can be a party to negotiable instrument but he does not incur any liability himself although other adult parties to the instrument

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remain liable thereon. Thus, though the minor cannot originate title or liability he can well serve as a channel or conduit pipe to pass it on to others. When an instrument is signed by a minor and adult jointly, the minor is not liable but the adult is.

As in the case of every other contract, so in the case of a negotiable instrument, the minor is in a privileged position. For, although he cannot incur liability under a negotiable instrument, he can acquire rights under it. He can be a promisee and therefore an instrument can be drawn or made in his favour as payee. He can also become an indorsee by subsequent transfer of the instrument in his name. He can thus be a holder 'entitled to sue', through his guardian, all parties liable under the instrument.

Insolvent. An insolvent is not competent to draw, make, accept or indorse a negotiable instrument so as to bind his estate which now stands vested in the Official Receiver. But if he indorses an instrument of which he is the payee or indorsee to a holder in due course, the indorsement is valid as against all prior parties liable except himself (*i.e.*, the insolvent).

Joint stock company. A company being an artificial person is competent of doing only such acts as are expressly or impliedy allowed by its Memorandum of Association. Hence if a company executes (*i.e.*, draws, accepts or negotiates) a negotiable instrument without being authorised to do so by its Memorandum of Association, the instrument is void and even a holder in due course cannot enforce the same against the company. A trading company has an implied power to execute negotiable instruments, but a non-trading company has no such power unless expressly authorised by its Memorandum of Association.

Although a company cannot incur liability under a negotiable instrument unless expressly or impliedly (as being incidental or ancillary to the attainment of its main objects) permitted by its Memorandum of Association, but it can always acquire rights under it. It can be a payee, or indorsee or holder and can enforce payment of the amount of the instrument. The position of the company as regards *rights* under a negotiable instrument is similar to the case of a minor.

Agent. Every person who has the capacity to incur liability as a party to negotiable instrument (*i.e.*, who can himself make, draw, accept or negotiate an instrument) may draw, make, accept or negotiate so as to become a party to a negotiable instrument through a duly authorised agent acting in his name. But a general authority to transact business and to receive and discharge debts does not confer upon an agent the power of accepting or indorsing bills of exchange so as to bind his principal. Further, an authority to draw bills of exchange does not of itself import an authority to indorse. (Sec. 27) Thus, an agent can execute negotiable instruments so as to bind his principal in that capacity (*i.e.*, as a drawer, maker, acceptor

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or indorser) only for which he is expressly authorised by the principal in very clear terms.

Further, while signing an instrument, the agent must make it clear that he is signing as an agent by using words like 'for and on behalf of' or '*per pro,*' otherwise he will be personally liable, except to those who induced him to sign upon the belief that the principal only would be held liable. (Sec. 28)

Legal representative. A legal representative of a deceased person who signs his name to a negotiable instrument (either as a maker or drawer or acceptor or indorser) is liable personally thereon unless he expressly limits his liability to the extent of the assets inherited by him from the said deceased (Sec. 29). Thus, in order to avoid personal liability a legal representative must, while signing an instrument, use words to indicate that he is not personally liable, *e.g.*, he may add words like 'without recourse to me personally' or 'with recourse against the estate of the deceased only.'

Liability of Parties to Negotiable Instruments

The provisions of law regarding the liability of parties to negotiable instruments are as follows:

Liability of drawer. "The drawer of a bill of exchange or cheque is bound, in case of dishonour by the drawee or acceptor thereof, to compensate the holder, provided due notice of dishonour has been given to, or received by, the drawer as hereinafter provided"[2] (Section 30). Thus, the drawer of a bill or cheque is liable to the holder only if *(i)* the instrument has been dishonoured, and *(ii)* due notice of dishonour has been given to him. In the case of an 'accommodation bill,' however, no notice of dishonour to the drawer is required (Sec. 98).

It is to be noted that the liability of a drawer of a bill of exchange is *secondary* like a surety (*i.e.*, he is liable to pay only if the acceptor fails to pay and on dishonour the holder can sue the acceptor or approach the drawer for payment), except in a case where the bill has been dishonoured by non-acceptance by the drawee, in which case he is *primarily liable* like a principal debtor to the holder. The liability of a drawer of a cheque, though arises only when the drawee bank fails or refuses to pay, is not secondary like the drawer of a bill because on dishonour while the holder of a cheque cannot sue the banker, the holder of a bill can sue the acceptor. Once the banker dishonours a cheque, its holder's remedy is only against the drawer. In this sense it may be said that the liability of the drawer of a cheque is *primary* (*Punjab National Bank* vs *Bank of Baroda*[3]).

Liability of drawee of cheque (Sec. 31). The drawee of a cheque (*i.e.*,

[2]For *rules regarding notice of dishonour,* see Chapter 29.
[3]A.I.R. (1944), P.C. 58.

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paying banker) must pay the cheque when duly presented for payment provided he has sufficient funds of the drawer applicable to the payment of such cheque. If the drawee banker wrongfully dishonours the cheque he can be made liable to pay exemplary damages *to the drawer*. Notice that when the banker makes a default he is liable not towards the payee or the holder but towards the drawer. This is so because there is no privity of contract between the holder and the banker. The holder has a remedy against the drawer and not against the banker.

Liability of 'maker' of note and 'acceptor' of bill (Sec. 32). The maker of a promissory note and the acceptor of a bill of exchange are the principal debtors and hence they are primarily liable for the amount due on the instrument according to its apparent tenor, in the absence of a contract to the contrary. There may be a contract to the contrary, for instance, in the case of an 'accommodation bill' the acceptor may be exempt from liability as per contract. Remember that the maker of a note or the acceptor of a bill must make the payment thereof according to the apparent tenor of the note or bill respectively *at or after maturity* to the holder. For, if he makes payment of a pre-mature bill or note, as the case may be, and the same is subsequently endorsed over, it is valid in the hands of a holder in due course and the acceptor or maker will be liable to pay again on the instrument.

Liability of indorser (Sec. 35). When an indorser indorses and delivers a negotiable instrument before maturity he impliedly undertakes to be liable to every subsequent holder for the loss caused to him if the instrument is dishonoured by the party primarily liable thereon. Thus the indorser stands in the position of a "drawer" to all the subsequent holders. Like a drawer, the indorser's liability is secondary and conditional. He is liable to every subsequent holder only if the following conditions are fulfilled:

(i) the instrument must have been dishonoured by the party primarily liable to pay the instrument on its maturity *i.e.*, by the drawee, acceptor or maker,

(ii) due notice of dishonour must have been given to or received by such indorser,

(iii) he must not have excluded his own liability by "*sans recourse*" indorsement, and

(iv) the holder must not have destroyed his remedy against prior parties, *e.g.*, cancellation of prior indorsements without his consent.[4]

Nature of liability of various prior parties. Every prior party, namely, the maker or drawer, the acceptor, and all the intervening indorsers; to a negotiable instrument is liable thereon to a holder in due course until the instrument is duly satisfied by payment or otherwise gets dis-

[4]Condition no. iv is based on Section 40.

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charged[5] (Sec. 36). Accordingly, the liability of prior parties to a holder in due course is *joint and several*. He may hold any or all the prior parties liable for the amount of the dishonoured instrument.

ILLUSTRATION. A bill drawn by *P* on *Q* in favour of *R* is made payable three months after date. It is indorsed by *R* in favour of *X*, by *X* in favour of *Y*, and by *Y* in favour of *Z*. The bill has been accepted by *Q*, and *Z* presents it on maturity for payment to *Q* who duly pays the amount and indorses the fact of payment of the bill. On payment by *Q* the bill is duly satisfied. But if payment had not been made, *Z* could sue *P, Q, R, X, Y* -all or any of them; *Y* could sue *P, Q, R, X; X* could sue *P, Q, R* and so on.

Liability Inter se. Though various parties to a negotiable instrument could be liable thereon but the nature of liability of each one of them is not similar. Some of them are primarily liable like a principal debtor while the others are secondarily liable like a surety. Section 37 provides in this connection that the maker of a promissory note or cheque, the drawer of a bill of exchange until acceptance and the acceptor are, in the absence of a contract to the contrary, respectively liable thereon as principcpal debtors. The parties other than those stated above (*i.e.*, the *drawer* of a bill after acceptance and the *indorser* on instrument being indorsed) are liable as sureties for those who are liable as principal debtors, that is, they are liable only in case the principal debtors fail to perform their contracts.

Section 38 deals with the nature of the liability between successive parties. It provides that "as between the parties so liable as sureties, each prior party is, in the absence of a contract to the contrary, also liable thereon as a principal debtor in respect of each subsequent party." As such each prior party is liable as a principal debtor to succeeding party and hence can claim payment from his preceding party only.

ILLUSTRATION. *A*, draws a bill payable to his own order on *B*, who accepts. *A*, afterwards indorses the bill to *C, C* to *D*, and *D* to *E*. As between *E* and *B, B* is the principal debtor, and *A, C* and *D* are his sureties. As between *E* and *A, A* is the principal debtor, and *C* and *D* are his sureties. As between *E* and *C, C* is the principal debtor and *D* is his surety.[6] Thus if the acceptor *B* does not pay on maturity, the holder in due course *E* can claim payment from any prior party and if he claims it from *C, D* is the principal debtor and *D* is *C*'s surety. *C* can now

[5]In certain circumstances an instrument gets discharged by operation of law and as a result the holder cannot make any prior party, liable thereon. For instance, when the primary party liable becomes insolvent, the instrument is discharged and the payee holder cannot make any prior party liable thereon because here the acceptor or maker is *unable to pay*. It is only on refusal to pay that prior parties are liable. An instrument is also discharged when it becomes time barred against all the parties thereto or contains some material alteration. For details *see* Chapter 29.

[6]Illustration to Section 38.

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claim the amount from *B* or *A* and not from *D*. If *B* and *A* are insolvent, *C* will suffer the loss.

In case the holder of a negotiable instrument agrees to grant release to the party primarily liable thereon from his liability or to grant him extension of time, all the intervening parties shall be discharged from liability, except when the holder has expressely, by a special contract, reserved his right against them (Sec. 39). Further, if the holder, without the consent of the indorser, destroys or impairs the indorser's remedy against prior party, *e.g.*, by cancellation of a prior indorsement *or* by destruction or release of securities held by him, the indorser is discharged from liability to the holder to the same extent as if the instrument had been paid at maturity. (Sec. 40)

TEST QUESTIONS

1. Explain the terms *(a)* holder and *(b)* holder in due course.
2. Distinguish between a 'holder' and a 'holder in due course.' Explain fully the privileges granted to a 'holder in due course' under the Negotiable Instruments Act.
3. 'A holder in due course gets a title free from equities' Explain the statement and discuss the various privileges of a holder in due course.
4. "The capacity to incur liability on negotiable instruments is co-extensive with the capacity to contract.' Explain the statement and discuss the different cases of incapacity to incur liability as a party to negotiable instrument.
5. Discuss the liability of various parties to negotiable instruments.
6. Discuss the liability of prior parties on a negotiable instrument to a subsequent holder and among themselves, in case of its dishonour.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. *A* draws a cheque in favour of *B*, a minor. *B* indorses it in favour of *C*, who in turn indorses it in favour of *D*. The cheque is dishonoured by the bank. Discuss the rights of *C* and *D*.

[Hint. *C* and *D* cannot claim from *B*, who being a minor does not incur any liability on the cheque (Sec. 26). *C* can claim payment from *A*, the drawer, only and *D* can claim against *C*, the indorser and *A*, the drawer.]

2. A bill is payable to '*M* or order'. It is stolen from *M* and the thief forges *M*'s signature and indorses it to *B* who takes it as a holder in due course. Discuss the rights of *B* on the bill.

[Hint. *B* acquires no title to the bill and cannot recover on it. The bill in question bears a forged indorsement. *A* forged indorsement being a nullity can convey no title and therefore *B* cannot claim to be holder the due course.]

3. *A* is the holder of a bill of exchange made payable to the order of *B*, which contains the following indorsements in blank:

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First indorsement by '*B*'.
Second indorsement by 'Peter Williams.'
Third indorsement by 'Wright & Co.'
Fourth indorsement by 'John Rozario.'

On this bill *A* puts in a suit against John Rozario and strikes out, without John Rozario's consent, the indorsements by Wright & Co., and Peter Williams. Will *A* Succeed?

[**Hint.** No, *A* will not succeed. By striking out indorsements by Wright & Co., and Peter Williams, *A* has impaired the remedy of John Rozario against them and so John Rozario is discharged from liability on the bill. (See Illustration to Section 40).]

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Chapter 27

Presentment of Negotiable Instruments

Exhibiting, presenting or placing of a negotiable instrument for acceptance, sight or payment before the acceptor, maker, drawee or other party liable thereon by or on behalf of the holder is called 'presentment.' Thus presentment may be made for any of the following three purposes:

I. Presentment for acceptance.
II. Presentment for sight.
III. Presentment for payment.

PRESENTMENT FOR ACCEPTANCE

'Presentment for acceptance' is necessary in case of bills of exchange only. But it is not every bill which has to be presented for acceptance. A bill of exchange 'payable on demand', *or* 'payable on the expiry of certain period after date' (say, payable three months after date), *or* 'payable on the date of happening of an event which is certain to happen' (say, on the death of Mr *X*) need not be presented for acceptance and it becomes due for payment even otherwise. The following bills, however, must be presented for acceptance in order to charge the parties with liability:

(a) A bill payable at a specified period *after sight.* Such a bill must be presented to the drawee for sight or acceptance in order to fix the maturity of the bill. (Sec. 61)

(b) A bill in which there is an express stipulation that it shall be presented for acceptance before it is presented for payment.

Even where presentation is optional, it is advisable to present the bill to the drawee for his acceptance in order to get *(i)* the additional security of the acceptor's name on the bill, or *(ii)* an immediate right of recourse against the drawer and the indorsers, if any, in case the bill is dishonoured by non-acceptance. From the drawer's point of view also presentment for acceptance is desirable, for if acceptance is refused, he may, on receiving early notice of dishonour, be able to get his effects out of the hands of the drawee.

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Acceptance

When the drawee of the bill signifies his consent in *writing* to the drawer's order in the bill, by *signing* across the face of the bill with or without the word 'accepted' and *delivers* back the bill to the holder or gives notice of acceptance to the holder, the bill is said to have been accepted. The drawee is not liable on a bill until he gives his acceptance and thereby becomes the acceptor thereof. A bill may be accepted even before the drawer has signed it or after notice of the drawer's death.

Types of acceptance. An acceptance on the bill may be either *(i)* general acceptance, or *(ii)* qualified acceptance.

(i) General acceptance. If the drawee accepts the order of the drawer to pay the sum specified in the bill in full, without any condition or qualification, the acceptance is said to be general, absolute or unqualified. The acceptor may mention the bank where payment shall be made and this does not amount to putting a condition. As a rule, in order to be valid, an acceptance must be 'general' or unconditional.

(ii) Qualified acceptance. (Sec. 86). When the drawee accepts the bill subject to some condition or qualification, thereby varying the terms as expressed in the bill, it is said to be a qualified acceptance. For example, acceptance for an amount less than that mentioned in the bill *or* for a period longer than that specified in the bill *or* acceptance dependent upon the happening of an event *or* acceptance to pay only at a specified place and *not elsewhere* or to pay at a place different from the place mentioned in the bill is a qualified acceptance. When the bill is drawn on two or more drawees, not being partners, and only one or some of them accept, it is also a qualified acceptance. In case of partners, acceptance by one of the partners is a general acceptance.

The holder may refuse to take a qualified acceptance and regard the bill dishonoured by non-acceptance. The holder may, at his option, accept qualified acceptance. If he accepts such qualified acceptance, without the consent of the prior parties, the latter are discharged from their liability. A qualified acceptance makes the bill an invalid negotiable instrument and thereafter the bill will be treated as an ordinary contract of acknowledging debt.

Presentment by Whom?

Only a 'holder' of the bill or his agent can present a bill for acceptance. It means that the drawer himself or the indorsee, if the bill has been negotiated before acceptance, or his agent can present the bill for acceptance.

Presentment to Whom?

A bill can be presented for acceptance to any one of the following:

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1. *The drawee* of the bill or his duly authorised agent (Secs. 61 and 27).

2. *All the drawees* where there are several drawees. But if some of the drawees have the authority from others to accept, as in case of partnership firm, presentment to a person having such an authority or to a partner is enough. A bill accepted by some of the several drawees, who are not partners, binds only those who accept it and not the others who do not accept it and the acceptance is a qualified acceptance (Sec. 34)

3. *The legal representative* in case the drawee is dead (Sec. 75). The legal representative would be personally liable by such an acceptance unless accepted 'sans recourse' (Sec. 29).

4. *The Official Receiver* in case the drawee has become insolvent (Sec. 75).

5. *The drawee in case of need i.e.,* the person whose name is mentioned in the bill as one to whom the bill is to be presented in case of its dishonour by the original drawee (Secs. 33 and 115).

6. *An acceptor for honour.* In certain circumstances a stranger to the bill may also accept it for the honour of any party—drawer or indorser liable on the bill. This is known as 'acceptance for honour' or 'acceptance supra-protest.' Section 108 lays down that "when a bill of exchange has been noted or protested for non-acceptance or for better security, any person not being a party already liable thereon may with the consent of the holder, by writing on the bill, accept the same for the honour of any party thereto." Thus, for a valid acceptance for honour it must be made: *(i)* after the bill has been noted or protested; *(ii)* by a stranger to the bill; *(iii)* in writing on the bill; *(iv)* with the consent of the holder.

The acceptor for honour must by writing on the bill declare that he accepts under protest the protested bill for the honour of the drawer or of a particular indorser whom he names, or generally for honour (Sec. 109). Where the acceptance does not express for whose honour it is made, it shall be deemed to be made for the honour of the drawer (Sec. 110).

Rights and liabilities of acceptor for honour. On acceptance the acceptor for honour takes exactly the same position as the party for whose honour he accepts. His rights and liabilities are the same with the only difference that his liability is conditional and arises only after:

(i) the bill has been again presented to the original drawee for payment at its maturity and has been dishonoured by him, and

(ii) noting and protesting has been done for such dishonour by non-payment.

If the acceptor for honour makes payment without the fulfilment of the above conditions, none will be liable to him, not even the original drawer. (Sec. 111 and 112)

Payment for honour. The essentials of a valid payment for honour are:

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(a) The bill must have been noted and protested for non-payment.

(b) The acceptor for honour making payment must declare before a notary public the party for whose honour he is paying which must be duly recorded by the Notary Public. (Sec. 113)

An acceptor for honour, on making a valid payment of the bill, is entitled to recover from the party for whose honour he has paid and from all parties prior to such party, all sums paid by him with interest thereon and with all expenses properly incurred in making such payment. All parties subsequent to the party for whose honour the payment has been made are discharged from liability. (Sec. 114) It will be seen that this Section, by allowing an acceptor for honour to recover the amount paid by him from the party for whose honour he has paid or from other parties prior to such party, makes an exception to the general rule of law that 'no person by voluntarily paying the debt of another, can make himself his creditor.'

Time for Presentment

The rules with regard to time of presentment for acceptance are as follows:

1. The presentation for acceptance must be made on a business day within business hours, whether the parties are traders or non-traders (Sec. 61).

2. Where presentation for acceptance is obligatory, *i.e.*, where the bill is expressed payable at a specified period *after sight,* the bill must, if no time is specified therein for presentation, be presented within a reasonable time after it is drawn (Sec. 61).

3. Where period of presentment is specified in the bill, it must be presented within that period.

Place of Presentment

If a particular place has been specified in the bill for presentment for acceptance, it must be presented at that place. If at such a place the drawee cannot be found on the due date for presentment, after reasonable search, the bill is dishonoured. (Sec. 61) If no place is mentioned in the bill, it may be presented at the usual place of business of the drawee or his residence.

Proof of Presentment

There must be a definite proof of presentment for acceptance and the drawee's refusal for the same. In order to declare 'dishonour by non-acceptance' the holder must prove before the Notary Public with the help of witnesses that the bill was in fact presented to the drawee for his acceptance or that the drawee could not be found after reasonable search, and such proof must be duly recorded by the Notary Public.

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Where authorised by agreement or usage, a presentment through the post office by means of a registered letter is sufficient (Sec. 61).

Drawee's Time for Deliberation

The holder must, if so required by the drawee of a bill of exchange presented to him for acceptance, allow the drawee forty-eight hours (exclusive of public holidays) to consider whether he will accept it (Sec. 63). Thus if the drawee wants time for deliberation before taking up liability, the holder is bound to allow him forty-eight hours time at the most. If the holder allows the drawee more than forty-eight hours, exclusive of public holidays, for deliberation, all previous parties not consenting to such extension of time are thereby discharged from liability to such holder (Sec. 83). If the drawee does not return the accepted bill within forty-eight hours the holder should treat the bill as dishonoured. If the drawee gives acceptance, it has retrospective effect and dates back to the date of the presentation.

Presentment for Acceptance When Excused?

In the following cases presentment for acceptance is excused and the bill is deemed to be dishonoured for non-acceptance even without presentment for acceptance:

1. When the drawee is incompetent to contract or he is a fictitious person (Sec. 91).

2. When the drawee, even after a reasonable search, cannot be found (Sec. 61).

Effect of Non-presentment

Where presentation for acceptance is obligatory, *i.e.*, where the bill is payable at a specified period *after sight,* and the holder fails to present the bill for acceptance, all parties thereto, *i.e.*, the drawer and the indorsers, if any, are discharged from their liability to such a holder (Sec. 61).

PRESENTMENT FOR SIGHT

"Presentment for sight" is necessary only in the case of a promissory note which is made payable *at a certain period after sight,* so that the maturity of the note may be ascertained. According to Section 62, "a promissory note, payable *at a certain period after sight,* must be presented to the maker thereof for sight (if he can after reasonable search be found) by a person entitled to demand payment, within a reasonable time after it is made and in business hours on a business day. In default of such presentment, no party thereto is liable thereon to the person making such default."

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PRESENTMENT FOR PAYMENT

Promissory note, bill of exchange and cheques must be presented for payment on the due dates. On default of such presentment the parties thereto, other than the maker, acceptor or drawee, are not liable thereon to the holder of the instrument (Sec. 64)

Presentment by whom? The presentment for payment is to be made by the person who can give valid discharge to the debtor, *i.e.*, either by the holder or by his authorised agent, or in case of his death or insolvency, by his legal representative or Official Assignee, as the case may be. Where authorised by agreement or trade usage, a presentment through the post office by means of a registered letter is sufficient. (Sec. 64)

Presentment to whom? The presentment for payment of promissory notes, bills of exchange and cheques must be made to the maker, acceptor or drawee thereof respectively (Sec. 64). It may also be made to the duly authorised agent of the maker, acceptor or drawee, as the case may be, or, where the maker, acceptor or drawee has died, to his legal representative, or, where he has been declared an insolvent, to his Official Assignee (Sec. 75).

Time of Presentment for Payment

The rules with regard to time of presentment for payment as laid down in the Act are as follows:

1. Presentment for payment must be made during the usual hours of business and if payable at a bank, during the usual banking hours (Sec. 65).

2. A negotiable instrument payable otherwise than on demand, *i.e.*, payable at a specified period after date or sight thereof, must be presented for payment at maturity (Sec. 66). Earlier presentment is premature and ineffective, and even a day's delay would discharge the parties thereto except one which is primarily liable.

3. A negotiable instrument payable on demand must be presented for payment within a reasonable time after it is received by the holder, otherwise the parties thereto except one which is primarily liable will be discharged from their liability (Secs. 74 and 73).

4. A cheque, which is always payable on demand, should be presented for payment not only within a reasonable time after delivery thereof but also before the relation between the drawer and his banker has been altered to the prejudice of the drawer (*i.e.*, before the bank has failed), otherwise even the party primarily liable, namely, the drawer will also be discharged from his liability to the extent of loss suffered by him on account of the delay (Secs. 72 and 84).

When delay in presentment is excused (Sec. 75A). Delay in present-

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ment (for acceptance or payment) is excused if the same is caused by circumstances beyond the control of the holder, and not imputable to his default, misconduct or negligence. Thus, delay on account of impracticability of transmitting the instrument to the place of payment because of postal strike is excusable. But when the cause of delay ceases to operate, presentment must be made within a reasonable time.

Reasonable time (Sec. 105). In determining what is a reasonable time for presentment for acceptance or payment regard shall be had to the nature of the instrument and the usual course of dealing with respect to similar instruments; and, in calculating such time, public holidays shall be excluded.

Place of Presentment for Payment

The Act lays down the following rules regarding the place of presentment for payment:

1. Where in an instrument the precise address of the place of payment has been indicated by the maker, drawer or acceptor, it must be presented at that place for payment (Secs. 68 and 69). For example, if a bill has been accepted 'payable at his bankers', the bill must be presented at the acceptor's bank and a presentment to the acceptor personally will be insufficient. However, if alternative places of payment have been mentioned then the instrument may be presented for payment at either of the places.

2. Where no place of payment has been indicated, the note or the bill must be presented at the place of business (if any), or at the usual residence of the maker, drawee or acceptor, as the case may be (Sec. 70).

3. If the maker, drawee or acceptor of a negotiable instrument has no known place of business or fixed residence, and no place is specified in the instrument for presentment for acceptance or payment such presentment may be made to him in person wherever he can be found (Sec. 71).

If there is a default in making the presentment in accordance with the above rules, the parties to the instrument, other than the maker, acceptor or drawee thereof, are not liable thereon to the holder. Non-presentment for payment discharges only the drawer and the indorsers in the case of a bill of exchange, and the indorsers, if any, in the case of a promissory note (Sections 68-69 read with Section 64).

When Presentment for Payment Unnecessary (Sec. 76)

No presentment for payment is necessary, and the instrument may be taken to be dishonoured on the due date for presentment, in any of the following cases:

1. *When presentment is intentionally prevented.* Where the maker, acceptor or drawee intentionally does something which prevents the holder

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from presenting the instrument, *e.g.*, where a promissory note is lost and the maker refuses to give a duplicate.

2. *Place of business closed.* If the instrument is payable at the payer's place of business and he closes such place on a business day during the usual business hours.

3. *Payer absents from place of payment.* If the instrument is payable at some other specified place, neither the payer nor any person authorised to make payment attends at such place during the usual business hours.

4. *When the payer cannot be found.* If the instrument is not payable at any specified place and the payer cannot after due search be found.

5. *Waiver of presentment.* If the person entitled to the presentment, namely, the payer waives the presentment and promises to pay even though no presentment is made. Such waiver may be made either expressly or impliedly. An *express waiver* may be made *before maturity* by expressly adding in the instrument such words as 'presentment waived'. An *implied waiver* will be inferred from the conduct of the maker, acceptor or drawee, when *after maturity* he makes a part payment on account of the amount due on the instrument or promises to pay the amount due thereon in whole or in part.

6. *Where drawer could not suffer damage.* Where the drawer is not likely to suffer damage by non-presentment for payment, *e.g.*, where drawee is a fictitious person or one incompetent to contract *or* where the drawer and the drawee are the same person, the presentment is excused as against the drawer and a holder can make the drawer liable without presentation.

TEST QUESTIONS

1. Discuss the rules regarding 'presentment for acceptance' of a negotiable instrument. State the circumstances under which such presentment is excused.

2. Define 'acceptor for honour'. Explain his rights and liabilities.

3. What are the rules governing presentment for payment of promissory notes, bills of exchange and cheques? When is such presentment unnecessary?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A*, draws a bill of exchange payable after 60 days on *B*. *B* accepts it payable after three months. Is it a valid acceptance?

[**Hint.** No, it is not a valid acceptance. It is a qualified acceptance and the holder may, at his option, accept it or regard the bill as dishonoured by nonacceptance.]

2. *X* draws a bill of exchange on *Y*. *Z* writes an acceptance on it. Is it a valid acceptance?

[**Hint.** No, it is not a valid acceptance. A stranger to the bill cannot accept it

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unless it is done for the honour of a party liable on the bill after the bill has been noted or protested for non-acceptance. As in the instant case the bill has not been noted and protested, Z cannot be termed as an 'acceptor the honour' and hence he cannot be held liable on the basis of his acceptance.]

3. A promissory note is presented for payment five days after its maturity. Are the *(i)* maker and *(ii)* indorser discharged by such delay?

[**Hint.** The indorser is discharged by the delay but the maker continues to be liable. Delay in presentment for payment discharges parties to the instrument other than the party which is primarily liable.]

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Chapter 28

Negotiation of Negotiable Instruments

Easy transferability being one of the essential features of negotiable instruments, they are frequently transferred from one person to another for making payment and discharging business obligations. Generally the person who is entitled to receive the payment of a negotiable instrument (*i.e*, the holder) does not retain it till maturity but transfers it to one of his creditors in payment of his debt, who in turn again transfers it to his creditor and so on the ownership of a negotiable instrument continues to be transferred from one to another. This process of transferring the title or ownership of negotiable instruments is called 'negotiation.'

Definition. According to Section 14, "when a promissory note, bill of exchange or cheque is transferred to any person, so as to constitute that person the holder thereof, the instrument is said to be negotiated." Thus negotiation implies a transfer of negotiable instrument so as to constitute the transferee a holder thereof, who should be entitled in his own name to sue on the instrument and recover the amount due thereon. Handing over a bearer instrument to a servant for safe keeping is not negotiation; there must be a transfer with intention to pass title and in the manner prescribed by the Act.

Who can negotiate? Every maker, drawer, payee or indorsee, and if there are several makers, drawers, payees or indorsees, all of them jointly can negotiate an instrument, provided the negotiability of such instrument has not been restricted or excluded by any express words used in the instrument. But the maker, drawer, payee or indorsee cannot negotiate an instrument, unless he is in lawful possession or is holder thereof. (Sec. 51)

Duration of negotiability. A negotiable instrument may be negotiated until payment or satisfaction thereof by the maker, drawee or acceptor at or after maturity, but not after such payment or satisfaction (Sec. 60). Thus, negotiability of an instrument stops only when the party ultimately liable thereon pays it at or after maturity. It can be negotiated even at or after maturity if it has not been paid or satisfied. A payment before maturity does

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not stop negotiability. The acceptor or maker who receives the instrument after payment but before maturity may reissue it.

Negotiation and Assignment Distinguished

The Negotiable Instruments Act does not prohibit transfer of negotiable instruments otherwise than by negotiation. The equitable title to the instrument may also be transferred by *'assignment'* by a separate deed in writing in accordance with the Transfer of Property Act. The various points of distinction between negotiation and assignment are stated below:

1. **Formalities.** Negotiation requires mere 'delivery' of a 'bearer' instrument and 'indorsement and delivery' of an 'order' instrument to effectuate a transfer. Assignment requires a written document signed by the transferor irrespective of whether the instrument is a 'bearer' or 'order' one.

2. **Notice of transfer.** In the case of assignment a notice of transfer of debt is required to be given by the assignee to the debtor in order to complete his title. No such notice is required to be given in the case of negotiation.

3. **Title.** In the case of negotiation if the transferee takes the negotiable instrument for value and in good faith, *i.e*, as holder in due course, he takes it free from all defects in the title of the previous transferors. But in the case of assignment, the assignee takes the instrument subject to the defects in the title of his assignor, even though he took the assignment for value and in good faith.

4. **Consideration.** Consideration is always presumed in the case of transfer by negotiation, whereas there is no such presumption in the case of transfer by assignment, where the burden of proof of consideration lies upon the assignee.

From the foregoing differences it will be seen that the rights which the transferee of a negotiable instrument by negotiation acquires are substantially superior to those of an assignee under assignment, and it is for this reason that the method of transfer by assignment is very rarely used while transferring negotiable instruments.

Modes of Negotiation

There are two ways of negotiating or transferring a negotiable instrument:

1. **Negotiation by mere delivery.** A negotiable instrument payable to bearer is negotiable by delivery thereof (Sec. 47). Thus, a bearer instrument may be negotiated by delivery only. It does not require signature of the transferor (*i.e.*, indorsement) and the transferee becomes the holder thereof by mere possession. The transferor of a bearer instrument is not liable on its dishonour because by not signing as indorser he has not added his credit to the instrument.

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2. **Negotiation by indorsement and delivery**. A negotiable instrument payable to order is negotiable by the holder by indorsement and delivery thereof (Sec. 48). Thus the negotiation of an order instrument requires two formalities, namely, first the holder should indorse it and then deliver to his indorsee.

Importance of delivery in negotiation. It may be noted that in both the modes of negotiation stated above, *delivery* made voluntarily with the intention of transferring the ownership of the instrument to the transferee is essential. Mere delivery without the intention of passing the property is not sufficient to constitute a complete negotiation. If a person delivers a negotiable instrument to his servant for safe custody or to his solicitor for filing a suit, the delivery does not amount to negotiation and the servant or the solicitor acquires no title to the instrument. Similarly, if the holder of a negotiable instrument payable to order makes the indorsement but dies before delivering the same to the indorsee, the negotiation is not complete and his legal representative cannot negotiate the same by mere delivery thereof (Sec. 57). It is so because there is no valid delivery since the instrument has not been voluntarily delivered by the deceased himself. Thus, delivery with the intention of passing the property in the instrument to the person to whom it is delivered is an essential formality to complete any contract on a negotiable instrument whether it be a contract of making, indorsement or acceptance (Sec. 46).

Delivery of a negotiable instrument may be *(a)* actual, *(b)* constructive, or *(c)* conditional. Delivery is actual when the instrument is physically handed over by the transferor to the transferee or to someone on his behalf. Constructive delivery is effected without any change of actual possession. It implies a delivery in the eyes of law.

ILLUSTRATIONS. *(a) A*, the holder of a negotiable instrument payable to bearer, which is in the hands of *A*'s banker, who is at the time the banker of *B* also, directs the banker to transfer the instrument to *B*'s credit in the Banker's account with *B*. The banker does so, and accordingly now possesses the instrument as *B*'s agent. The instrument has been negotiated, and *B* has become the holder of it. [Illustration *(b)* to Section 47]

(b) A, indorses a promissory note in favour of *B* and holds it, on *B's* request, as *B*'s agent. There is constructive delivery by *A* to *B*.

Where the instrument is delivered with some condition attached, it is called a conditional delivery. In such a case the negotiation is not valid, *i.e.*, the property in the instrument does not pass to the transferee, till the condition is fulfilled. However, if it is subsequently negotiated to a holder in due course, he will get a good title to it and all prior parties shall be liable to him in spite of initial conditional delivery.

ILLUSTRATION. *P* delivers a bearer cheque to *Q* on the condition that *Q* will not encash or negotiate the cheque unless he supplies him with the goods.

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There is a conditional delivery by *P* to *Q* and the property in the cheque will pass to *Q* only on supplying the goods. If the indorsee *i.e.*, *Q*, encashes the cheque before supplying the goods, *P* can recover the money so paid to him. But if *Q* negotiates the cheque to *R*, who takes the same in good faith and for value, he becomes the holder in due course and can rightfully encash the cheque.

Indorsement

Section 15 defines indorsement as follows:

"When the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as negotiable instrument, he is said to indorse the same, and is called the indorser."

Thus, an indorsement consists of the signature of the holder usually made on the back of the negotiable instrument with the object of transferring the instrument.[1] If no space is left on the back of the instrument for the purpose of indorsement, further indorsements are signed on a slip of paper attached to the instrument. Such a slip is called 'allonge' and becomes part of the instrument. The person making the indorsement is called an 'indorser' and the person to whom the instrument is indorsed is called an 'indorsee.'

In order to be a valid indorsement it should be made in ink. An indorsement in pencil or by a rubber stamp is invalid. The indorser (*i.e.*, the payee) must sign his name in the exact spellings as appearing on the face of negotiable instrument or the preceding indorsement. If the payee is an illiterate person, he may indorse the instrument by affixing his left hand thumb impression thereon, but the same should be duly witnessed or attested by somebody who should give his full address thereon. Indorsements shall be presumed to have been made in the order in which they appear on the instrument unless proved to the contrary.

Kinds of Indorsements

Indorsements may be of the following kinds:

1. **Blank or general indorsement.** If the indorser signs his name only and does not specify the name of the indorsee, the indorsement is said to be in blank [Sec. 16(1)]. The effect of a blank indorsement is to convert the order instrument into bearer instrument (Sec. 54), which may be transferred merely by delivery.

[1]Signing at the back of the instrument before surrendering the same to the payer (*i.e.*, banker, acceptor or maker) for payment, merely acts as a receipt for money and not as indorsement because the payer does not occupy the position of a holder.'

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2. **Indorsement in full or special indorsement.** If the indorser, in addition to his signature, also adds a direction to pay the amount mentioned in the instrument to, or to the order of, a specified person the indorsement is said to be in full [Sec. 16(1)]. If, for example, *A*, the holder of a bill of exchange, wants to make an indorsement in full to *B*, he would write thus: "Pay to *B* or order, Sd/A.' After such an indorsement it is only the indorsee, *i.e. B*, who is entitled to receive the payment of the instrument and to further negotiate the instrument by his indorsement.

A blank indorsement can easily be converted into an indorsement in full. According to Section 49, the holder of a negotiable instrument indorsed in blank may, without signing his own name, by writing above the indorser's signature a direction to pay to any other person as indorsee, convert the indorsement in blank into an indorsement in full; and since such holder does not sign himself on the instrument he does not thereby incur the responsibility of an indorser.

3. **Partial Indorsement.** Section 56 provides that a negotiable instrument cannot be indorsed for a part of the amount appearing to be due on the instrument. In other words, a partial indorsement which transfers the rights to receive only a part payment of the amount due on the instrument is invalid. Such an indorsement has been declared invalid because it would subject the prior parties to plurality of actions (one action by holder for part value and another action by indorsee for part value) and will thus cause inconvenience to them. Moreover, it would also interfere with the free circulation of negotiable instruments. It may be noted that an indorsement which purports to transfer the instrument to two or more indorsees separately and not jointly is also treated as partial indorsement and hence would be invalid. Thus, where *A* holds a bill for Rs 2,000 and indorses it in favour of *B* for Rs 1,000 and in favour of *C* for the remaining Rs 1,000, the indorsement is partial and invalid.

Section 56, however, further provides that where an instrument has been paid in part, a note to that effect may be indorsed on the instrument and it may then be negotiated for the balance. Thus, if in the above illustration the acceptor has already paid Rs 1,000 to *A*, the holder of the bill, *A* can then make an indorsement saying "Pay *B* or order Rs 1,000 being the unpaid residue of the bill." Such an indorsement would be valid.

4. **Restrictive indorsement.** Stating the effect of indorsement Section 50 provides that "the indorsement of a negotiable instrument followed by delivery transfers to the indorsee the property therein *with the right of further negotiation."* However, Section 50 permits restrictive indorsement. An indorsement which, by express words, prohibits the indorsee from further negotiating the instrument or restricts the indorsee to deal with the instrument as directed by the indorser is called 'restrictive' indorsement.

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The indorsee under a restrictive indorsement gets all the rights of an indorser except the right of further negotiation. In other words, such an indorsement entitles the indorsee to receive the payment on due date and sue the parties for it but he cannot further negotiate the instrument.

ILLUSTRATIONS. *(a)* *B*, the holder of the bill, makes an indorsement on the bill saying "Pay *C* only." It is a restrictive indorsement as *C* cannot negotiate the bill further.[2]

(b) *B*, the holder of the bill, makes an indorsement on the bill, saying "Pay *C* for my use" *or* "Pay *C* or order for the account of *B*." In either case there is a restrictive indorsement as the right of further negotiation by *C* has been excluded thereby.[3] The person liable on the bill must pay by drawing a cheque in the name of the holder (or the indorser) *B*. If he makes the payment to *C* on *C*'s own account, he will still be liable to *B*, the indorser. Hence *C* cannot indorse the bill further in his own name.

5. **Conditional indorsement.** If the indorser of a negotiable instrument, by express words in the indorsement, makes his liability, dependent on the happening of a specified event, although such event may never happen, such indorsement is called a 'conditional' indorsement (Sec. 52). The law permits a conditional indorsement and therefore it does not in any way affect the negotiability of the instrument. Thus, indorsements can validly be made in the following terms:

(i) "Pay *B* or order on his marriage;"

(ii) "Pay *B*[4] on the arrival of Pearless ship at Bombay."

In the case of a conditional indorsement the liability of the indorser would arise only upon the happening of the event specified. But the indorsee can sue other prior parties, *e.g.*, the maker, acceptor, *etc.*, if the instrument is not duly met at maturity, even though the specified event did not happen.

6. **Sans recourse indorsement** (Sec. 52). When the indorser expressly excludes his own liability on the negotiable instrument to the indorsee or any subsequent holder in case of dishonour of the instrument, the indorsement is known as 'sans recourse' indorsement. Such an indorsement is generally made by adding the words 'sans recourse' or 'without recourse.' Thus, "Pay *X* or order sans recourse" or "Pay *X* without recourse to me" or "Pay *X* or order at his own risk" are examples of this type of indorsement.

7. **Facultative indorsement.** When the indorser expressly gives up some of his rights under the negotiable instrument, the indorsement is

[2]See *Illustration (a)* to Section 50.

[3]See *Illustrations (b)* and *(c)* to Section 50.

[4]The negotiability is not restricted by the omission of the word "or order" (Sec. 51).

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called a 'facultative' indorsement. Thus, "Pay *X* or order, notice of dishonour waived" is a facultative indorsement. As a result of such an indorsement the indorsee is relieved of his duty to give notice of dishonour to the indorser and the latter remains liable to the indorsee for the non-payment of the instrument, even though no notice of dishonour has been given to him.

Negotiation Back

During the course of negotiation if a negotiable instrument is reindorsed by the last indorsee to the original holder or a previous indorser it is called as 'negotiation back.' The person who becomes the holder by reason of negotiation back cannot make any of the intermediate indorsers liable on the instrument because to make them liable would involve a circuity of action; he having ultimately to sue himself as being a prior party he is liable to all of them. But where an indorser excludes his liability by the use of the words 'sans recourse' or 'without recourse to me,' and afterwards becomes the holder of the instrument in his own right, all intermediate indorsers are liable to him and in case of dishonour he can recover the amount from all or any one of them [Sec. 52, Para 2].

NEGOTIATION BY UNAUTHORISED PARTIES

We shall now discuss about the negotiation of lost instruments and instruments obtained by unlawful means (*e.g.*, by theft or fraud) or for unlawful consideration.

Lost Instruments

The following rules are applicable in the case of lost negotiable instruments:

1. Where a bill of exchange has been lost before it is over-due, the person who was its holder may apply to the drawer to give him another bill of the same tenor. The drawer may require the holder to give security to indemnify him against all persons whatever in case the bill alleged to have been lost shall be found again. If the drawer on request as aforesaid refuses to give such duplicate bill, he may be compelled to do so by means of a suit (Sec. 45A). The right to obtain a duplicate of lost instrument is given to the holder of a promissory note or a cheque also.

2. To avoid the risks involved in case of loss of a negotiable instrument, its holder should inform all parties liable on it and should also give public notice by advertisement in some local newspaper.

3. If the holder could not obtain a duplicate copy, he should on maturity make an application to the person liable to pay on the lost instrument

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for payment of the amount due thereon. Although the payer is entitled to refuse payment till the instrument is delivered to him, he may make the payment after getting a written undertaking from the payee to indemnify him against any further claim thereon. In case the payer insists on delivery of the instrument and rufuses to pay otherwise, then payment can be obtained through court on similar undertaking to indemnify. (*See* Sec. 81)

4. The finder of the lost instrument gets no title to it and cannot sue the party liable thereon for its payment. The rightful holder (or the true owner) is entitled to get back the instrument from him. But if the finder obtains payment of the instrument in his possession, it being a bearer document, the payer (*i.e.*, the maker, acceptor or drawee) will be discharged from his liability if he makes a payment in due course. The true owner, however, will be entitled to recover the amount from the finder. (*See* Secs. 58 and 82)

5. Although the finder of the lost instrument, in the absence of title to it, cannot lawfully transfer it, but if he negotiates it, being a bearer instrument or one indorsed in blank, to a holder in due course, such holder gets a good title to it and can obtain payment from the party concerned. (Sec. 58) The true owner cannot take possession of the same from such a holder in due course, of course he can claim damages from the finder, if traceable.

6. In case the finder transfers an order instrument by making a forged indorsement, even a *bonafide* transferee for value gets no legal title to it, and therefore he is not entitled to sue on the instrument. Forgery can confer no title and thus indorsee is not a holder in due course. If the party liable to pay on the instrument makes the payment to the indorsee who holds it under a forged indorsement, he shall continue to be liable to the true owner. (Protection has, however, been given by law to a paying banker in such a case).

Stolen Instruments

The position in case of a stolen negotiable instrument is almost the same as in the case of a lost instrument, with the difference that on being traced the thief is open to criminal prosecution while a finder is not. Here also, the thief does not acquire any title to the instrument and the true owner can sue him for the recovery of the instrument or the money if he has received it from the maker, acceptor or drawee. But if the thief transfers a bearer instrument to a holder in due course, such a holder gets a good title to it (Sec. 58).

Instruments Obtained by Fraud

If a person obtains a negotiable instrument by fraud, undue influence or coercion, he is not entitled to enforce its payment as his title is defective. But if such an instrument (bearer or order) is transferred to a holder in due

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course, such a holder will acquire good title to it and the plea of fraud will not be of use against him. It may be noted that in the case of instruments obtained by fraud etc., even an order instrument can be negotiated so as to make the indorsee a holder in due course because it is not a case of the absence of title (as in the case of lost or stolen instruments) but only a case of defective title and hence the indorsement shall not be a forged one. The indorsement in this case will be genuine, though by a person having a defective title, but once the instrument passes into the hands of a holder in due course, it is purged of all its defects (Sec. 58).

Instruments Obtained for an Unlawful Consideration

The general rule of law of contracts that every agreement of which the object or consideration is unlawful or immoral or against the public policy is void and inoperative applies to negotiable instruments for unlawful consideration as well. Thus, a bill of exchange or a promissory note given in consideration of future illicit co-habitation or for reimbursing someone for committing a crime is void and creates no obligation between the parties thereto. But if such an instrument passes into the hands of a holder in due course, such a holder and any holder deriving title from such a holder in due course gets a good title to the instrument (Sec. 58).

Forged Instruments

If the signature of maker, drawer or acceptor is forged on a negotiable instrument, it is termed a forged instrument. A forged signature is in law wholly inoperative and therefore a forged instrument is deemed incomplete on the face of it. It has no existence in the eye of law. It is totally ineffective and a nullity. It cannot confer any right or create any liability. Hence the holder of a forged instrument cannot enforce it and if he obtains payment on such instrument, the person making the payment can recover the amount paid by him as payment under a mistake. Even if, in the course of negotiation, a forged instrument passes through the hands of a holder in due course it cannot be cured of its defect because there is no defect of title which can be cured but there is a complete absence of title.

Forged indorsement. If the signature of indorser is forged on a negotiable instrument it is called a forged indorsement. A forged indorsement is regarded in law as no indorsement at all. As a result the indorsee of an *order instrument* bearing a forged indorsement gets no title thereto, even if he is a *bonafide* holder for value, because in law he has taken an instrument which was incomplete on the face of it. The indorsee of an order instrument obtains title only through the indorsement made by the indorser and the same being forged one cannot confer any title on the indorsee. The title of the indorser whose indorsement has been forged remains unaffected.

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If the party liable to pay on the instrument makes the payment to the indorsee who holds it under a forged indorsement, he shall continue to be liable to the true owner. Protection has, however, been granted to a paying banker who pays in due course its customer's cheque payable to order and bearing a forged indorsement (Sec. 85).

In the case of a bearer instrument or the one which has been indorsed in blank, a forged indorsement is immaterial and does not affect the title of the indorsee. For, in case of such instruments the indorsee or holder derives title by delivery and not through the indorsement.

It is relevant to state that where a person accepts a bill of exchange already carrying forged indorsement with full knowledge of forgery, he is not relieved from liability by reason that such indorsement is forged (Sec. 41).

Negotiation of Dishonoured and Overdue Instruments

Dishonoured and overdue instruments may be negotiated but the transferee of such an instrument will not be termed as a holder in due course. Section 59 provides that the holder of a negotiable instrument, who has acquired it after dishonour whether by non-acceptance or non-payment, with notice thereof, or after maturity, is not a holder in due course and his title will not be better than that of his transferor. Such a holder can recover only from his immediate preceding party in case of dishonour and not from any prior party like a holder in due course.

The case of an accommodation bill or note is, however, different. The proviso to Section 59 lays down that any person who, in good faith and for consideration, becomes the holder, after maturity, of an accommodation bill of exchange or an accommodation promissory note, is a holder in due course in the same way as a holder before maturity and can recover the amount of the bill or note from any prior party.

Instruments Without Consideration

Unlike ordinary contracts, in the case of negotiable instruments there is a presumption of consideration. Until contrary is proved there shall be a presumption that every negotiable instrument was drawn, made, accepted, indorsed, negotiated or transferred for consideration [Sec. 118 *(a)*]. The presumption is rebuttable by a person who wants to avoid his liability on the ground of absence of consideration. The rights of the parties to negotiable instruments without consideration or with partial consideration are discussed below:

Total absence or failure of consideration. According to Section 43, "a negotiable instrument made, drawn, accepted, indorsed or transferred

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without consideration, or for a consideration which fails, *creates no obligation of payment between the parties to the transaction.* But if any such party has transferred the instrument (with or without indorsement) *to a holder for consideration* such holder, and every subsequent holder deriving title from him, may recover the amount due on such instrument from the transferor for consideration or any prior party thereto."

Partial consideration. According to Sections 44 and 45, when there is a partial failure of consideration, either originally or subsequently, the parties standing in immediate relation to each other cannot recover more than the actual consideration. But this rule does not apply to a holder in due course who can recover the full amount due on such instrument.

Thus, the absence of consideration, either total or partial, in case of a negotiable instrument can be taken as a defence to avoid the liability only towards parties to the transaction, *i.e.*, those parties who have *immediate relation* with one another. Want of consideration cannot be a valid defence to a suit brought by a subsequent holder in due course or any other person deriving title therefrom and such a holder in due course may recover the amount due from any prior party. Accordingly, a person who might have accommodated the drawer of the bill, shall be liable on the bill to any subsequent 'holder for value', even if the holder knew such party to be an accommodation party.

According to the Explanation added to Section 44, the drawer of a bill of exchange stands in immediate relation with the acceptor. The maker of a promissory note, bill of exchange or cheque stands in immediate relation with the payee, and the indorser with his indorsee.

ILLUSTRATIONS. *(a) A* makes a promissory note in favour of *B* and delivers the same to *B* without consideration. *B* indorses the same to *C* without consideration. *C* indorses it to *D* for consideration and *D* indorses it to *E* without consideration. *B* cannot recover anything from *A*, as there was no consideration between them. Similarly, *C* also got it without consideration from *B* and thus cannot claim the amount of the note from *B*. *D* is the transferee for consideration and therefore *D* can claim the amount from *C*, as also from *B* and *A*, because a person who takes a negotiable instrument for consideration can claim the amount *from the transferor for consideration or any prior party thereto.* Not only *D* can have rights against *A*, *B* and *C* but any person who derives title from *D*, *i.e.*, *E* in the instant case, can claim payment from *A*, *B* and *C*, *E*, however, cannot bring any action against *D*, because as between *E* and *D*, who stand in immediate relation with each other there was no consideration.

(b) A is the holder of a bill for consideration. *A* indorses it away to *B* without consideration. The property in the bill passes to *B*. The bill is dishonoured at maturity. *B* cannot sue *A* on the bill as there was no consideration between them.

(c) A draws a bill on *B* for Rs 500 payable to the order of *A*. *B* accepts the bill, but subsequently dishonours it by non-payment. *A* sues *B* on the bill. *B* proves

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that it was accepted for value as to Rs 400, and as an accommodation to the plaintiff as to the residue. *A* can only recover Rs 400. [Illustration to Section 44]

TEST QUESTIONS

1. Explain clearly what is meant by negotiation. State the differences between negotiation and assignment.

2. What is an indorsement? Explain and illustrate the different kinds of indorsements.

3. "A partial indorsement does not operate as a negotiation of the instrument." Comment. Describe the different kinds of indorsements.

4. What are the requisites of a valid indorsement? Explain the different kinds of indorsements with suitable examples.

5. Discuss the rules regarding negotiation of a lost instrument, a forged indorsement, an instrument obtained by fraud and for an unlawful consideration.

6. *(a)* Can an overdue instrument be negotiated?

(b) "The absence of consideration for a negotiable instrument is material only between immediate parties to the instrument." Comment.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. A bill is payable to '*B* or order'. It is stolen by *C* who forges *B*'s indorsement and indorses it to *D* who takes it for value and in good faith. Does *D* acquire good title to it?

[Hint. No, *D* does not acquire good title to the bill because a forged indorsement is no indorsement in the eye of law and as such cannot confer any title on the indorsee.]

2. A cheque is drawn payable to '*B* or order.' It is stolen and *B*'s indorsement is forged. The banker pays in due course. Is the banker discharged from liability?

[Hint. Yes, the banker is discharged from liability as per Section 85.]

3. *A* draws a bill on *B* who accepts it without consideration. *A* indorses the bill to *C* for valuable consideration. On due date *C* presents the bill to *B* for payment but *B* contends absence of consideration and refuses to pay. Is *B*'s contention justified?

[Hint. No, *B*'s contention is not justified against *C* who is a holder of the bill for value, even if *C* knew that *B* is an accommodation party. *B* is liable on the bill to *C*. Absence of consideration can be taken as a defence to avoid liability only towards parties who stand in immediate relation with each other.]

4. *X*, the holder of a bill, transfers it to *Y* without consideration. *Y* transfers the bill to *Z* without consideration but *Z* transfers to *M* for consideration. *M* transfers it to *N* without consideration. Can *N* hold *M*, *Z*, *Y* or *X* liable for payment?

[Hint. *N* can hold *X*, *Y* or *Z* liable on the bill, for he derives title from *M* who has taken the bill for consideration. *N*, however, cannot make *M* liable because of absence of consideration between them.]

5. *M* obtains *P*'s acceptance to a bill by fraud. *M* indorses it for *Q* who takes

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it as a holder in due course. Q indorses the bill to R who knows of the fraud. Can R recover from P?

[**Hint.** Yes, R can recover from P, because he takes the bill from a holder in due course and once an instrument passes through the hands of a holder in due course it is purged of all defects.]

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Chapter 29

Dishonour and Discharge of Negotiable Instruments

DISHONOUR OF NEGOTIABLE INSTRUMENTS

A negotiable instrument may be dishonoured by *(i)* non-acceptance or *(ii)* non-payment. As presentment for acceptance is required only in case of bills of exchange, it is only the bills of exchange which may be dishonoured by non-acceptance. Of course any type of negotiable instrument — promissory note, bill of exchange or cheque — may be dishonoured by non-payment.

Dishonour by Non-acceptance

A bill of exchange is said to be dishonoured by non-acceptance in the following cases:[1]

1. When the drawee or one of several drawees (not being partners) makes default in acceptance upon being duly required to accept the bill. It may be recalled that the drawee may require 48 hours time (exclusive of public holidays) to consider whether he will accept or not (Sec. 63).
2. Where the presentment for acceptance is excused and the bill is not accepted, *i.e.*, remains unaccepted.
3. Where the drawee is incompetent to contract.
4. Where the drawee makes the acceptance qualified.
5. If the drawee is a fictitious person or after reasonable search cannot be found (Sec. 61).

It is important to note that where a 'drawee in case of need' is named in a bill of exchange, the bill is not dishonoured until it has been dishonoured by such drawee (Sec. 115).

Dishonour by Non-payment

A promissory note, bill of exchange or cheque is said to be dishonoured

[1]Section 91

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by non-payment when the maker of the note, acceptor of the bill or drawee of the cheque makes default in payment upon being duly required to pay the same (Sec. 92). Also, a promissory note or bill of exchange is dishonoured by non-payment when presentment for payment is excused expressly by the maker of the note or acceptor of the bill and the note or bill remains unpaid at or after maturity (Sec. 76).

Effect of Dishonour

As soon as a negotiable instrument is dishonoured (either by non-acceptance or by non-payment) the holder becomes entitled to sue the parties liable to pay thereon. The drawer of cheque, maker of note, acceptor and drawer of bill and all the indorsers are liable severally and jointly to a holder in due course.[2] The holder *must,* however, give 'notice of dishonour' to all parties against whom he intends to proceed. He *may* (at his option) also have the instrument 'noted and protested' before a notary public.

Notice of Dishonour

Notice of dishonour means formal communication of the fact of dishonour. It is given to the party sought to be made liable and, therefore, it serves as a warning to the person to whom the notice is given that he could now be made liable. Such a notice also serves the purpose of enabling the person so notified to protect himself against his prior parties.

Notice by whom? Notice of dishonour must be given by the holder or by some party to the instrument who remains liable thereon (Sec. 93). Further, any party receiving notice of dishonour must also transmit the same within a reasonable time to all prior parties in order to render them liable to himself. He cannot sue any prior party to whom he has not transmitted the notice unless that party has received due notice from the holder or some other party to the instrument (Sec. 95). It may be noted that where a number of persons are required to give notice to certain persons it is not necessary that all of them must give the notice. If some of them have given notice of dishonour, the other persons can take advantage of the same.

Notice of dishonour can also be given by the duly authorised agent of the person who is bound to give notice. When an instrument is deposited with an agent for presentment and is dishonoured the agent can himself give notice to prior parties on behalf of the holder. But it is not obligatory on him to do so. He may give notice to his principal within the same time as if he were the holder and the principal may then give notice to parties to whom he wants to hold liable. The principal is also entitled to a further like

[2]For further details about the liability of parties to a negotiable instrument refer to Ch. 26.

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period to give notice of dishonour (Sec. 96).

Notice to whom? Notice of dishonour must be given to all parties (other than the maker of a note, acceptor of a bill or drawee of a cheque) to whom the holder seeks to make liable or to their duly authorised agents. Where there are two or more persons jointly liable as drawers or indorsers, notice to any one of them is sufficient. No notice need be given to the maker of a note, or acceptor of a bill or drawee of a cheque who are the principal debtors and have themselves dishonoured the instrument (Sec. 93). In case of death of a person, notice must be given to his legal representative, or, where he has been declared an insolvent, it must be given to his Official Assignee (Sec. 94). When the party to whom notice of dishonour is despatched is dead, but the party despatching the notice is ignorant of his death, the notice is sufficient to bind the estate of the deceased (Sec. 97). Thus if the fact of death is known to the holder a notice addressed to the dead person is a nullity. In such a case notice must be addressed to his legal representative.

Mode of giving notice. According to Section 94 the notice of dishonour may be oral or written. If it is written it may be sent by post. A notice duly addressed and posted is good even though it may be miscarried. The notice may be in any form but the language used must indicate that the instrument has been dishonoured and in what way dishonoured, and that the recipient will be held liable thereon. It should be given within a *reasonable time* after dishonour, at the place of business or (in case such party has no place of business) at the residence of the party for whom it is intended.

What is reasonable time? In determining what is a reasonable time for giving notice of dishonour, regard shall be had to the nature of the instrument, the usual course of dealing with respect to similar instruments and the distance between the parties, and, in calculating such time, public holidays shall be excluded (Sec. 105). Section 106 further provides that if the holder and the party to whom notice of dishonour is given carry on business or live (as the case may be) in different places, such notice shall be deemed to be given within a reasonable time if it is despatched by the next post or on the day next after the day of dishonour. If the said parties carry on business or live in the same place, such notice is within reasonable time if it is despatched in time to reach its destination on the day next after the day of dishonour.

If a party who receives the notice of dishonour is to transmit the same to his own prior parties, the transmission is within reasonable time if he transmits it within the same time *after its receipt* as he would have had to give notice if he had been the holder (Sec. 107).

When notice of dishonour is unnecessary. Notice of dishonour is not

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necessary, *i.e.*. the parties are liable without any notice of dishonour in the following cases mentioned in Section 98:

1. When it is dispensed with by the party entitled to the notice. For example, where the indorser while signing in that capacity adds the words 'notice of dishonour waived,' no notice of dishonour is required.

2. When the drawer of a cheque has countermanded payment, no notice of dishonour is required to charge the drawer.

3. When the party charged could not suffer damage for want of notice. For example, when the cheque is dishonoured because the drawer had closed his account with the banker,[3] or in case of accommodation bills, no notice of dishonour to the drawer is required.

4. When the party entitled to notice cannot, after due search, be found; or the party bound to give notice is, because of some justifiable reason (*e.g.*, death, accident or serious illness), unable to give it.

5. When the drawer also happens to be the acceptor.

6. In the case of a promissory note which is not negotiable. Since such a note is not negotiable, the payee ought not to indorse it, and if it is indorsed, the indorsee cannot have any claim against the maker of the note or the indorser. Therefore no one is prejudiced for want of notice.

7. When the party entitled to notice promises to pay unconditionally the amount due on the instrument after dishonour and with full knowledge of facts.

Consequences of not giving notice of dishonour. Any party to a negotiable instrument (other than the maker of a note, acceptor of a bill or drawee of a cheque) to whom notice of dishonour is not sent by the holder is discharged from his obligation under the instrument and cannot be sued by the holder, unless the circumstances are such that no notice of dishonour is required to be sent. The drawer or indorser who has not received notice is discharged not only on the bill or note but also in respect of the original consideration (*Mohd. Raffi* vs *Qazi Mahzar*[4]).

Noting

'Noting' is the authentic and official proof of presentment and dishonour of a negotiable instrument. The question of noting does not arise in the case of dishonour of a cheque because in such a case the bank, while refusing payment, returns back the cheque giving reasons in writing for the dishonour of the same, and that itself acts as an authentic evidence of the fact of dishonour. Even in the case of inland bills or notes noting is not compulsory (Sec. 104).

[3] *Punjab National Bank* vs *Iqbal Singh*, (1962), Punjab, 158.

[4] A.I.R. (1936), Lah. 796.

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According to Section 99, when a promissory note or a bill of exchange has been dishonoured by non-acceptance or non-payment, the holder may cause such dishonour to be noted by a Notary Public[5] upon the instrument, or upon a paper attached thereto, or partly upon each. For this the holder takes the bill or note to the notary public who makes a demand for acceptance or payment upon the drawee or acceptor or maker formally and on his refusal to do so notes the same on the bill or note. Thus 'noting' means recording the fact of dishonour on the dishonoured instrument or on a paper attached thereto for the purpose. Noting must be made within a reasonable time after dishonour and must specify: *(i)* the date of dishonour; *(ii)* the reason assigned for such dishonour; and *(iii)* the notary's charges.

Protest

'Protest' is a formal certificate of dishonour issued by the notary public to the holder of the bill or note, on his demand (noting is merely a record of dishonour on the instrument itself) (Sec. 100).

Protest for better security. Such protest can be made in the case of bills only. When the acceptor of a bill of exchange has become insolvent, or his credit has been publicly impeached, before the maturity of the bill, the holder may, within a reasonable time, cause a Notary Public to demand better security of the acceptor, and on its being refused, may within a reasonable time cause such facts to be noted and certified as aforesaid. Such certificate is called a protest for better security (Sec. 100, Para 2). It may be noted that in spite of such a protest the holder shall have to wait till the date of maturity to take any action against the acceptor, drawer or indorsers. The only advantage of protest for better security is that it enables the bill to be accepted for honour, for Section 108 provides that when a bill of exchange has been noted or protested for non-acceptance or for better security, the same can thereafter be accepted for honour.

Noting and protest of inland bills or notes is not compulsory, but foreign bills must be protested for dishonour if so required by the law of the place where they are drawn (Sec. 104).

Contents of protest (Sec. 101). The protest must contain the following particulars:

1. The instrument itself or a literal transcript of the instrument and of everything written or printed thereupon.
2. The name of the person for whom and against whom the instrument has been protested.
3. The fact and the reasons for dishonour, *i.e.*, a statement that payment

[5]'Notary Public' is an officer appointed by Government for the purpose of 'noting and protesting' as laid down in Negotiable Instruments Act.

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or acceptance, or better security, as the case may be, was demanded by the notary public from the person concerned and he refused to give it or did not answer, or that he could not be found.

4. The place and time of dishonour.

5. The signature of the Notary Public.

6. In the case of acceptance for honour or payment for honour, the names of the persons by whom and for whom it is accepted or paid.

DISCHARGE OF THE INSTRUMENT AND THE PARTIES

The term 'discharge' in relation to negotiable instruments has two connotations, *viz.*, (1) discharge of the instrument, and (2) discharge of one or more parties from liability on the instrument.

Discharge of the Instrument

A negotiable instrument is said to be discharged when it becomes completely useless, *i.e.* no action on that will lie, and it cannot be negotiated further. After a negotiable instrument is discharged the rights against all the parties thereto comes to an end, and no party, even a holder in due course, can claim the amount of the instrument from any party thereto.

Discharge of the party primarily and ultimately liable on the instrument results in the discharge of the instrument itself. For example, in the following cases the instrument is deemed to be discharged:

1. When the party primarily liable on the instrument (*i.e.*, the maker of the note, acceptor of the bill or drawee bank) makes the payment in due course to the holder at or after maturity (Sec. 78). A payment by a party who is secondarily liable does not discharge the instrument because in that case the payer holds it to enforce it against prior indorsers and the principal debtor.

2. When a bill of exchange which has been negotiated is, at or after maturity, held by the acceptor in his own right, the instrument is discharged (Sec. 90).

3. When the party primarily liable becomes insolvent, the instrument is discharged and the holder cannot make any other prior party liable thereon. Notice that in the case of insolvency, the acceptor or maker is unable to pay and it is only on refusal to pay that the instrument is deemed to be dishonoured and prior parties can be made liable thereon. Similarly, an instrument stands discharged when the primary party liable is discharged by material alteration in the instrument (Sec. 87), or by lapse of time making the debt time barred under the Limitation Act.

4. When the holder cancels the instrument with an intention to release the party primarily liable thereon from the liability, the instrument is discharged and ceases to be negotiable (Sec. 82).

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Discharge of One or More Parties

A party is said to be discharged from his liability when his liability on the instrument comes to an end. When only some of the parties to a negotiable instrument are discharged, the instrument continues to be negotiable and the undischarged parties remain liable on it. Thus, the discharge of one or more parties to an instrument does not discharge the instrument and the rights under it can still be enforced against those parties who continue to be liable thereon.

One or more parties to a negotiable instrument is/are discharged from liability in the following ways:

1. **By cancellation** [Sec. 82*(a)*]. When the holder of a negotiable instrument *deliberately* cancels the name of any of the party (by drawing a line through the name) liable on the instrument with an intent to discharge him from liability thereon, such party and all indorsers subsequent to him, who have a right of action against the party whose name is so cancelled, are discharged from liability. Thus, if the maker's or acceptor's name has been cancelled the liability of all other parties to the instrument, who must have obviously become parties thereto subsequent to the maker or acceptor and as such must be in the position of sureties to him, comes to an end, which in effect discharges or cancels the instrument itself. But if the name of an indorser has been cancelled then all the indorsers subsequent to him will be discharged but those prior to him will remain liable. Section 40 contains a similar provision, according to which if the holder, without the consent of the indorser, destroys or impairs the indorser's remedy against a prior party, the indorser is discharged from liability.

It is important to note that where the cancellation is done under a mistake, or without the authority of the holder it would be inoperative and will not discharge any party.

2. **By release** [Sec. 82 *(b)*]. If the holder of a negotiable instrument releases any party to the instrument by any method other than cancellation of names (*i.e.*, by a separate agreement of waiver, release, or remission), the party so released and all parties subsequent to him, who have a right of action against the party so released, are discharged from liability.

3. **By payment** [Sec. 82*(c)* and 78]. When the party primarily liable on the instrument makes the payment in due course to the holder at or after maturity, all the parties to the instrument stand discharged, because the instrument as such is discharged by such payment.

4. **By allowing drawee more than 48 hours to accept** (Sec. 83). If the holder of a bill of exchange allows the drawee more than forty eight hours[6], exclusive of public holidays, to consider whether he will accept the same,

[6]According to Section 63 the drawee is entitled to be allowed a period of 48 hours at the most (exclusive of public holidays) to consider whether he will accept the bill or not.

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all previous parties not consenting to such allowance are thereby discharged from liability to such holder.

5. **By taking qualified acceptance** (Sec. 86). If the holder of a bill agrees to a qualified acceptance all prior parties whose consent is not obtained to such an acceptance are discharged from liability.

6. **By not giving notice of dishonour.** Any party to a negotiable instrument (other than the party primarily liable) to whom notice of dishonour is not sent by the holder is discharged from liability as against the holder, unless the circumstances are such that no notice of dishonour is required to be sent.

7. **By non-presentment for acceptance of a bill** (Sec. 61). When a bill of exchange is *payable certain period after sight,* its holder must present it for acceptance to the drawee within a reasonable time after it is drawn. If he makes a default in making such presentment the drawer and all indorsers who were liable towards such a holder are discharged from their liability towards him.

8. **By delay in presenting cheque** (Sec. 84). It is the duty of the holder of a cheque to present it for payment within reasonable time of its issue.[7] If he fails to do so and in the meanwhile the bank fails causing damage to the drawer, the drawer is discharged as against the holder to the extent of the actual damage suffered by him.

9. **By material alteration.** Any material alteration of a negotiable instrument renders the same void, *i.e.*, discharges the instrument itself, and all parties thereto at the time of making such alteration and not consenting to the change are discharged from liability thereon (Sec. 87). But persons who become parties to the instrument after the alteration are liable under the instrument as altered. In other words, those who take an altered instrument cannot complain (Sec. 88).

It is worth noting that the material alteration of the instrument discharges all the parties liable thereon at the time of making such alteration, and it makes no difference whether the alteration is for the benefit or detriment to any party to the instrument[8] or whether it is made by the holder of the instrument or by a stranger while the instrument was in the custody of the holder, because the party in custody of the instrument is bound to preserve it in its integrity (*Davidson* vs *Cooper*[9]). But alteration made by a stranger without any negligence on the part of the holder does not affect the liability of the parties there to (*Guorochandra* vs *Krushna Charana*[10]).

What constitutes a material alteration? It is not every alteration that

[7]*See* Sections 64, 72 and 73.

[8]*Rampadarath* vs *Hari Narain,* A.I.R. (1965), Pat. 224.

[9](1844), 13 M. & W. 343.

[10]A.I.R. (1941), Madras 383.

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necessarily would affect the validity of an instrument or the rights of parties thereto. Only when the alteration is 'material,' the validity of the instrument or the rights of parties would come in for question. The Negotiable Instruments Act is silent on the question — what constitutes a material alteration? Courts in India have, therefore, followed the English Common Law and held that *anything which has the effect of altering the legal relations between the parties or the character of the instrument or the sum payable amounts to a material alteration.*[11]

The following are the examples of material alteration:

(i) Any alteration of the date, the sum payable, the time of payment and the place of payment.[12]

(ii) Alteration by the addition of a new party to the instrument (*Gardener* vs *Walsh*[13]).

(iii) Alteration of the rate of interest (*Verco Pvt. Ltd.* vs *Newandram*[14]).

(iv) Tearing off the material part of the instrument.

Alterations not vitiating the instrument. There is no material alteration so as to vitiate the instrument in the following cases, as they do not prejudice the rights and liabilities of the parties thereto:

(i) Alteration made for the purpose of correcting a mistake or a clerical error.

(ii) Alteration made to carry out the common intention of the original parties (Sec. 87).

(iii) Alteration made before the instrument is issued.

(iv) Alteration made with the consent of the parties liable on the instrument.

(v) Conversion of bearer cheque into an order cheque.

(vi) Filling blanks in the case of inchoate or incomplete instruments (Sec. 20).

(vii) Conversion of blank indorsement into an indorsement in full (Sec. 49).

(viii) Making qualified acceptance (Sec. 86).

(ix) Crossing of an uncrossed cheque (Sec. 125).

(x) Alteration which is the result of an accident, *e.g.*, mutilation by washing, ravages by white ants or rats, document torn by a child, document burnt in part by the hot end of a cigarette (*Hongkong and Shanghai Banking Corpn.* vs *Lo Lee Shi*[15]).

[11]Banking Laws Committee Report on Negotiable Instruments Law, 1975, p. 48.
[12]Sec. 64(2) of the (English) Bills of Exchange Act, 1882.
[13](1885), 5E. & B. 83.
[14]A.I.R. (1974), Madras 4.
[15](1928), A.C. 181 (P.C.).

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10. **By negotiation back of a bill.** When a bill of exchange comes back to the acceptor by process of negotiation and he becomes its holder, it is called as "negotiation back." If a bill of exchange which has been negotiated is, at or after maturity, held by the acceptor in his own right, all rights of action thereon are extinguished (Sec. 90).

TEST QUESTIONS

1. In what different ways may a negotiable instrument be dishonoured? What are the duties of a holder of a dishonoured bill?

2. How and when should a notice be served on a bill being dishonoured by either non-acceptance or non-payment? Under what circumstances is notice of dishonour unnecessary?

3. When are bills of exchange, promissory notes or cheques said to be dishonoured? Who should give notice of dishonour and to whom?

4. What is the difference between discharge of a negotiable instrument and discharge of a party to a negotiable instrument? When is a negotiable instrument said to be discharged? Give examples.

5. What are various ways in which one or more parties to a negotiable instrument is/are discharged from liability? Discuss.

6. In what manner is the liability of a drawer, aeceptor and indorser of a negotiable instrument discharged?

7. Explain the meaning of material alteration in a negotiable instrument. What is the effect of such alteration?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. *P* draws a bill on *Q* payable three months after sight. It passes through several hands before *R* becomes its holder. On presentation by *R*, *Q* refuses to accept. Discuss the duties and rights of *R* on the bill.

[**Hint**. On dishonour of the bill by non-acceptance, it is the duty of *R*, the holder, to give notice of dishonour to all prior parties. He may also have the instrument noted and protested. Thereafter *R* is entitled to make *P*, the drawer of the bill, liable as principal debtor and the intervening indorsers liable as sureties.]

2. *A* drew a cheque for Rs, 5,000 in favour of *B* on 1st January 1985, and gave it to him on the same day. The cheque was presented for payment on the 5th June 1985. In the meantime the bank had failed in May 1985. Discuss the legal position of *B*'s recourse against *A* and the Bank for recovering the amount.

[**Hint**. As *B* presented the cheque for payment after more than five months, which cannot be considered as reasonable period, and the drawer suffered loss due to this long delay, the drawer is discharged from his liability to the extent of the

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actual damage suffered by him. *B*, however, can claim as a creditor in the insolvency of the bank for the balance.]

3. A bill payable three months after date is altered to a bill payable three months after sight by the holder. The acceptor refuses to make payment. Can the holder enforce its payment against the acceptor or the drawer?

[**Hint.** No, the holder cannot enforce the payment of the bill against any party thereto as the bill has been materially altered. Material alteration renders the instrument void.]

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Chapter 30

Banker and Customer

A banker is one who does banking business. The Banking Regulation Act, 1949, defines a 'banking company' as a company which transacts the business of *banking* in India. The term 'banking' is defined as "accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or, otherwise, and withdrawable by cheque, draft, order or otherwise" [Sec. 5*(b)*, The Banking Regulation Act, 1949]. It may be emphasised that the primary function of a banking company consists of *accepting of deposits for the purpose of lending or investing the same*. If the purpose of accepting of deposits is not to lend or invest, *e.g*, where a trader accepts deposits of money from the public merely for the purpose of financing his business, the business will not be called the banking business. Another special feature of banking business is that the deposited money should be repaid to the depositor on demand or according to the agreement. The demand should be made through an order, cheque, draft or otherwise and not merely by verbal order.

The term 'customer' of a bank is not defined by law. Ordinarily, a person who has an account in a bank is considered to be a customer of the bank. But to constitute a customer of the bank in the technical sense, besides opening of an account with the bank it is also essential that the dealings with the banker must relate to the business of banking, *e.g.*, depositing and withdrawing money or taking loans. Merely availing of services rendered by the banker, *i.e.*, encashing a cheque, remitting money through a bank draft or depositing valuables in the safe deposit vaults in the bank, do not create the relationship of banker and customer.

CROSSING OF CHEQUES

Cheques may be of two types—*(i)* Open or uncrossed cheques and *(ii)* crossed cheques. An *open cheque* is payable at the counter of the drawee bank on the presentation of the cheque. Such a cheque runs great risk in the course of circulation because once a wrong person takes away the payment of an open cheque it is difficult to trace him. *A crossed cheque*

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is payable only through a collecting banker and not directly at the counter of the bank. Thus, crossing affords security and protection to the holder of the cheque because when payment of a cheque has been drawn through a banker it may easily be detected to whose use the money has been received. The collecting banker credits the proceeds to the account of the payee of the cheque.

A cheque is said to be crossed when two parallel transverse lines, with or without any words, are drawn on the left hand top corner of the cheque. It is relevant to state that such lines are essential for 'general crossing' and may not be drawn in case of 'special crossing.'

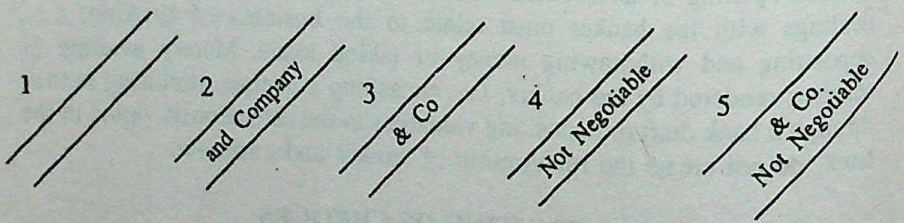
Crossing of a cheque does not affect its negotiability. A crossed cheque can be negotiated in the same way as uncrossed one, *i.e.*, it can be negotiated by mere delivery in case it is payable to bearer and by indorsement and delivery if it is payable to order.

Where the holder of a crossed cheque has no account in any bank then *either* he may open an account with some banker and pay the cheque in that account to enable the banker to collect its payment on his behalf and credit the same into his account, *or* he may obtain payment by indorsing the cheque in favour of some person who has got an account in any bank.

Types of Crossing

There are two types of crossing: (1) General or (2) Special.

1. **General crossing.** Where a cheque bears across its face (usually on the left hand top corner) two parallel transverse lines without any words or with words 'and company' (or & Co.) or/and 'not negotiable' written in between these two parallel lines, it is called general crossing (Sec. 123). Thus, general crossing may take any of the following forms:



Where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker (Sec. 126). In the case of general crossing, therefore, the holder may get the cheque collected through some bank. Collecting bank may be any bank of the choice of the holder.

2. **Special crossing.** Where a cheque bears across its face (transverse

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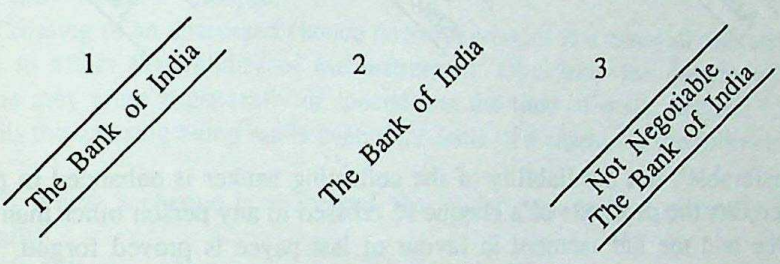
lines are not compulsory) an addition of the name of a banker, either with or without the words 'not negotiable,' that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed specially, and to be crossed to that banker (Sec. 124). Thus, special crossing may take any of the following forms:



Where a cheque is crossed specially, the banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed, or his agent for collection (Sec. 126). Thus, in the case of special crossing the paying banker is to honour the cheque only when it is presented through the banker mentioned in the crossing, or an agent of such bank (*i.e.*, another banker acting as agent for collection of that bank). According to Section 127, where a cheque is crossed specially to more than one banker, except when that bank to whom it has been specially crossed makes another special crossing in the name of another bank for the purpose of collection, the banker on whom it is drawn shall refuse payment thereof.

A special crossing makes the cheque more safer than a general crossing because now a thief will have to search an account-holder of that particular bank only whose name appears in the crossing which may create more difficulty.

Account Payee or Restrictive Crossing

To give still more protection to the payee of a cheque the practice of restrictive crossing is also prevalent in the business community. Such crossing can be made in both the cases of 'general' as well as 'special' crossing by adding the words 'Account Payee' (A/c Payee), 'Account Payee only' (A/c Payee only) or 'Account Alok Kuchhal only.' Thus, restrictive crossing may take any of the forms shown on next page.

The effect of 'Account Payee' crossing is that the collecting banker is supposed to credit the amount of the cheque to the Account of the payee only and nobody else. This should not be taken to mean that an 'Account Payee' crossed cheque cannot be negotiated further. Such a cheque remains

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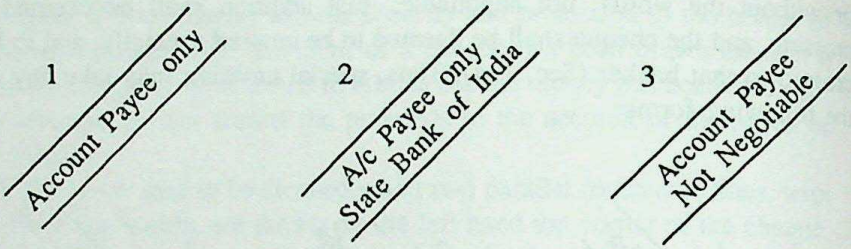
1 Account Payee only

2 A/c Payee only State Bank of India

3 Account Payee Not Negotiable



transferable[1], but the liability of the collecting banker is enhanced in case he credits the proceeds of a cheque so crossed to any person other than the payee and the indorsement in favour of last payee is proved forged. The banker will be held guilty of negligence in such a case and will not be entitled to the protection given under Section 131 (where a banker acting *bonafide* will not be liable to the true owner, if he receives payment of a crossed cheque for a customer whose title is defective).[2] Thus, the collecting banker must act like a blood hound and make proper enquiries as to the title of the last indorsee (whether indorsement in his favour is genuine or not) from the original payee named in the cheque before collecting an 'Account Payee' crossed cheque in his (*i.e.*, the last indorsee) account.

'Not Negotiable' Crossing

As stated earlier, the words 'Not Negotiable' may also be written in both types of crossing—'general' and 'special' (Secs. 123 and 124), and a crossing with these words is said to be 'Not Negotiable' crossing. Section 130 states the effect of such a crossing in the following words:

"A person taking a cheque crossed generally or specially, bearing in either case the words 'not negotiable,' shall not have, and shall not be capable of giving, a better title to the cheque than that which the person from whom he took it had.".

Thus, the effect of such a crossing is that it takes away one of the essential characteristics of a negotiable instrument, in the sense, that the transferee of such a crossed cheque cannot get a better title than that of the transferor (*i.e.*, cannot become the holder in due course) and cannot convey a better title to his own transferee, though the instrument remains transferable.

The object of 'not negotiable' crossing is to afford protection to the

[1]*National Bank* vs *Silke*, (1891), 1 Q.B. 415.

[2]For details *see* "*Protection to Collecting Banker*" discussed later in 2025 Chapter.

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holder or drawer of a cheque, because even if such a cheque goes to wrong hands and from there it is transferred to holder in due course, the true owner will not lose his claim against such an indorsee. Thus an indorsee of such a crossed cheque must not accept the cheque unless he knows the indorser very well and is convinced about his having a good title thereto.

Who may Cross a Cheque?

Crossing of an uncrossed cheque does not amount to a material alteration so as to affect the validity of the instrument. Obviously the drawer of a cheque may cross it generally or specially at the time of issue. Section 125 permits the crossing being made even *after issue* of a cheque in the following ways:

(i) Where a cheque is uncrossed, the holder may cross it generally or specially.

(ii) Where a cheque is crossed generally, the holder may cross it specially.

(iii) Where a cheque is crossed generally or specially, the holder may add the words 'not negotiable'.

(iv) Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker as his agent for collection.

Crossing once made becomes a material part of the cheque and only the drawer of the cheque is entitled to cancel or open the crossing by writing the words 'Pay Cash' and cancelling the crossing along with his full signature. Similarly, any alteration in the crossing, except in the ways stated above, must be authenticated by the signature of the drawer, otherwise the same will be treated as material alteration so as to discharge the instrument itself. Thus where a cheque is crossed 'Account Payee' and the holder alters it into a general crossing by striking out the words 'Account Payee,' the alteration is irregular and discharges the instrument.

Liability of Banker

The relationship between banker and customer primarily is that of a debtor and a creditor and therefore it is the prime duty of a banker to honour his customers' cheques unless there are valid reasons for refusing payment of the same. In case he dishonours a cheque without justification he is liable to compensate the customer (*i.e.*, the drawer) for any loss or any damage caused by such default (Sec. 31). It must be noted that the liability of the banker for wrongful refusal to pay a cheque is only towards the drawer and not towards the payee of the cheque. The payee has no right of action against the banker for refusing to honour the cheque for the simple reason that there is no privity of contract between him and the banker. He

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can, however, hold the drawer liable in damages for breach of contract.

The rule of awarding damages. In case of wrongful dishonour of cheque, a *non-trader* customer is entitled only to general damages for such monetary loss which he might have actually suffered. But a *trader or businessman* customer is entitled to claim not only the general damages, but special damages also for loss of credit or reputation in the market and even without proving the actual loss suffered by him. "In cases where a cheque issued by a trader customer is wrongfully dishonoured even special damages could be awarded without proof of special loss or damage. The fact that such dishonouring took place due to a mistake of the bank is no excuse nor can the offer of the bank to write and apologize to the payees of such dishonoured cheques affect the liability of the bank to pay damages for their wrongful act." (*New Central Hall* vs *United Commercial Bank Ltd.*[3]). In the case of a trader customer claiming damages, the rule of awarding damages is, 'the smaller the amount of the cheque wrongfully dishonoured the larger the amount of damages.'

When Banker 'Must Refuse' Payment of his Customer's Cheques

There are some cases when a banker *must refuse payment* of his customer's cheques without incurring any liability. In these cases the payment made is not good against the drawer and the banker will have to bear the loss himself or may recover it from the wrong payee, if traceable, in some cases only. The cases in which a banker is bound to dishonour his customer's cheques are as follows:

1. **When customer countermands payment.** When a customer countermands the payment, that is, issues instructions to the bank not to honour a particular cheque issued by him, the banker is bound to comply with such instruction. The countermand order must, however, be given in sufficient time before the banker actually makes the payment of the cheque. Oral countermand is sufficient. Any payment made by mistake after a due notice of countermanding the payment is not good against the drawer, nor is the banker entitled to a refund from the payee (because the payee gets payments of an otherwise valid cheque), and the banker will have to bear the loss caused by such payment.

2. **Garnishee order.** On receipt of the 'garnishee order,' *i.e.*, a prohibitory order by any court attaching money in customer's account, the banker is bound to dishonour the customer's cheques. If by mistake the banker makes payment of any cheque after the receipt of such an order, he will have to bear the loss himself. He cannot recover from the payee who gets payment of an otherwise valid cheque.

[3]A.I.R. (1959), Mad. 153.

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3. **Death, Insolvency or Insanity of the customer.** When the banker receives a notice that his customer has died, or has been adjudged insolvent, or has become insane, his authority to pay cheques drawn by the customer stands revoked and therefore he must not pay the cheques. Any payment made after a due notice is not good against the drawer, nor is the banker entitled to a refund from the payee, who gets payment of an otherwise valid cheque.

4. **Notice of assignment.** When the banker receives a notice of assignment of his credit balance from a customer, he must refuse payment of the cheques drawn by the customer. The banker would be liable if he makes the payment of any cheque after the receipt of such a notice.

5. **Defective title of the Party.** When the banker becomes aware of the defective title of the person presenting the cheque, *e.g.*, he is a thief, the banker must refuse to honour the cheque.

6. **Loss of cheque.** When the customer has informed the banker about the loss of the cheque, he must not pay it. In case the payment of such a cheque is made by mistake it is not good against the drawer but the banker can recover from the wrong payee, if traceable, as he is not entitled to possession and payment of the cheque.

7. **When the cheque is irregular.** When there is material alteration in the cheque or the signature of the drawer does not tally with the specimen signature kept in the bank, the banker must dishonour the customer's cheque. In case of payment by mistake the banker can recover from the wrong payee, if traceable, otherwise will have to bear the loss himself.

8. **Closing of account.** On receipt of the 'notice for closing the account' from the customer, the banker must not pay the customer's cheques. If the banker makes payment of any cheque after the receipt of such a notice, he will have to bear the loss himself.

When Banker 'May Refuse' Payment of his Customer's Cheques

There are some cases when a banker *may refuse payment* of his customer's cheques. In these cases, if payment is refused, the banker shall not be liable for damages, and if payment is actually made, the court will decide as to whether the payment made is good against the drawer (*i.e.*, the customer) or not, taking into account the various facts of the case. The cases in which a banker may dishonour his customer's cheques are as follows:

1. Where the cheque is post-dated and is presented before the ostensible date. A customer's order to pay a cheque is deemed to be made on the date it bears and therefore if the cheque is presented before that date the banker is justified in refusing the payment of the same. But if a banker pays a post-dated cheque, the payment is good against the drawer provided the cheque

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is not countermanded until the stated date. The banker honouring a post dated cheque, thus takes a great risk. Such a banker may also be made liable for damages to the customer if he is not able to meet the customer's other cheques presented within the intervening period.

2. When the balance to the credit of the customer's account is insufficient to meet the cheque and there is no overdraft arrangement.

3. When the funds of the customer in the hands of the banker are not properly applicable to the payment of such cheque. Thus, if the funds in his hands are earmarked for some specific purpose by the customer, or he is entitled to a set-off in respect of them, the said funds are not available for honouring the cheque and the banker may refuse the payment.

4. When the cheque is not properly presented, for example, it is presented at a branch where the customer has no account, or where the cheque is presented after banking hours, the banker is justified in dishonouring the cheque. But for personal reasons he may make the payment.

5. Where the cheque is not presented within a reasonable time of its issue. Ordinarily a period of six months is considered sufficient within which the cheque must be presented for payment. On the expiry of this period the cheque is treated as 'stale' and the banker may dishonour the same. He may, after getting the stale cheque confirmed by the drawer, honour it.

6. When the cheque is of doubtful validity, *i.e.*, it is drawn on a paper different from what has been issued by the bank, the bank may refuse payment. But if he so likes he may make the payment because legally a cheque can be totally handwritten and may be drawn on any paper.

It is relevant to state that where payment is refused, a holder can sue the drawer within three years from the date of issue of the cheque because a cheque becomes time-barred after three years from its date of issue.

Protection to the Paying Banker

The Negotiable Instruments Act provides special protection to a banker who honours his customer's cheques. The rationale of the protection may be explained as follows. While the paying banker knows the state of, and takes the responsibility for the authenticity of the signature of, the drawer, he cannot be presumed to have any special knowledge about the payee or other holders of the instrument. As such a paying banker acting in good faith and in the ordinary course of business should not be saddled with responsibility if the payee's title is subsequently found defective or wanting. Moreover, cheques have to be honoured or rejected promptly and the banker does not have time, nor necessary experience, to enable him to enquire or investigate about the identity of the person who presents the cheque for payment.

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Protection in case of order cheques. Section 85(1) provides protection to the paying banker in case of *order cheques* as follows: "Where a cheque payable to order purports to be indorsed by or on behalf of the payee, the drawee is discharged by 'payment in due course'."[4] Accordingly, the paying banker shall be discharged from liability if he makes payment of an order cheque to the payee or the apparent indorsee thereof in good faith and without negligence even though subsequently it may turn out that such an indorsement was forged. Thus, where *P* draws a cheque payable to *Q* or order and forwards the same to his agent *R* with instructions to hand it over to *Q* and *R* forges *Q*'s indorsement and collects payment of the cheque, the banker making payment in due course is discharged from liability and he can validly debit *P*'s account with the amount of this cheque.

This protection to a paying banker is an exception to the general rule that 'a forged indorsement is no indorsement in law.' In practice the banker usually gets the identity of the holder of an order cheque verified by some responsible man of the bank or by an account-holder, but this simply means that in case the indorsement of the payee subsequently comes out to be a forged one, the verifier will be liable to the original payee and not the banker.

The banker is also protected against forged indorsements in case of 'bank drafts' (Sec. 85A) and crossed cheques (Sec. 128), if he makes payment in due course.

Protection in case of bearer cheques. Section 85 (2) provides protection to the paying banker in respect of *bearer cheques* as follows: "Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any indorsement whether in full or in blank appearing thereon, and notwithstanding that any such indorsement purports to restrict or exclude further negotiation." Accordingly, where a cheque is originally issued as a bearer cheque, the banker may ignore any indorsements on the cheque. He shall be discharged by payment in due course to the bearer of the cheque. Thus, for the purpose of discharge of the paying banker from liability, once a bearer cheque always remains bearer cheque.

No protection when the drawer's signature is forged. A banker is not protected even by a payment in due course if the drawer's signature is forged, and as such if he makes payment on forged signature, he cannot debit the customer's account with such payment and will have to bear

[4]"Payment in due course" means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount therein mentioned (Sec. 10).

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himself the loss so caused (*Allahabad Bank* vs *Kul Bhushan*[5]). There is, however, one exception to this rule. Where the customer has been negligent and his negligence was the proximate cause of the wrong payment, for example, where the customer did not inform the banker immediately on becoming aware of the forgery, the banker can debit the customer's account with the amount so paid.

Protection to the Collecting Banker

A collecting banker is one who receives the payment of a crossed cheque on behalf of his customer. Section 131 grants protection to the collecting banker and states that "a banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment." Accordingly, if the collecting banker has collected a cheque on behalf of a person whose title to the cheque was defective, he would be protected and would not be held liable in 'conversion' to the true owner, provided he proves that:

(i) he acted in good faith and without negligence;

(ii) the cheque was already crossed before it reached his hands; and

(iii) he received the payment on behalf of a 'customer' and not on his own account, *i.e.*, he acted as an agent for collection and not in the capacity of holder for value.

It may be noted that if a banker credits his customer's account with the amount of the cheque before receiving payment thereof, he does not become a holder for value and the protection of this Section shall be available to such a collecting banker as well (Explanation to Sec. 131). This protection, however, is not available where the banker allows the proceeds of an "Account payee crossed cheque" to be credited to any account other than the payee and the indorsement in favour of the last payee is proved forged.

The protection afforded by Section 131 to the collecting banker is very valuable in view of the fact that when one person deals with the goods of another without his permission, he is liable to an action for 'conversion', and in the absence of this protection the position of the banker would not be different from that of any other person.

Right of Holder against Banker

As observed earlier, the liability of a banker for wrongful refusal to pay a cheque is only towards the customer (*i.e.*, the drawer) and not towards the holder or payee of the cheque. The holder has no right of action against the

[5]A.I.R. (1961), Punj. 471.

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banker for refusing to pay the cheque because there is no privity of contract between him and the banker. But the holder is entitled to enforce payment from the banker in the following two cases:

1. Where the holder does not present the cheque within a reasonable time of its issue and on account of the delay the drawer suffers actual damage by the failure of the bank and is therefore discharged to the extent of such damage, then the holder can prove his debt to the extent of such discharge against the banker in insolvency proceedings. The holder in such case shall be a creditor, in place of such drawer, of such banker to the extent of such discharge and can recover the amount from him. (Sec. 84)

ILLUSTRATION (appended to Section 84) *A* draws a cheque of Rs 1,000, and, when the cheque ought to be presented, has funds at the bank to meet it. The bank fails before the cheque is presented. The drawer is discharged, but the holder can prove against the bank for the amount of the cheque.

2. Where a banker pays a cheque crossed generally over the counter or a cheque crossed specially otherwise than to the banker to whom the same is crossed, he is liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid (Sec. 129). Of course the banker can recover from the wrong payee, if traceable.

BOUNCING OF CHEQUES

A cheque is said to be bounced or dishonoured by non-payment when the drawee of the cheque makes default in payment upon being duly required to pay the same. With a view to enhancing the acceptability of cheques in settlement of liabilities, it is necessary that the cheques drawn are honoured and not bounced.

To ensure better discipline in the matter of circulation and payment of cheques, the Negotiable Instruments Act, 1881 has been amended by the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988, which came into force on April 1, 1989. Apart from few minor amendments, the major amendment pertains to insertion of a new Chapter (Chapter XVII) in the Negotiable Instruments Act, whose heading is "Penalties in case of Dishonour of certain Cheques for Insufficiency of Funds in the Accounts". This Chapter comprises five Sections — Sections 138 to 142.

The salient features of the provisions of new Sections 138 to 142 are discussed below.

A drawer of a dishonoured cheque shall be deemed to have committed an offence and shall, without prejudice to any other provision of the Negotiable Instruments Act, be punishable with imprisonment for a term which may extend to one year, or with a fine which may extend to twice the

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amount of the cheque, or with both. However, before the penal provisions can be invoked against the drawer of a cheque which has bounced, the following requirements should be satisfied:

(1) The cheque should have been dishonoured due to insufficiency of funds standing to the credit of the account on which the cheque was drawn or for the reason that the amount of cheque drawn on the account exceeds the sanctioned limit of overdraft.

(2) The cheque should have been issued by the drawer in favour of *another person* for the discharge of legally enforceable debt or other liability, in whole or in part. Therefore, when any cheque issued for meeting social obligations, such as charity, marriage presents, birthday gifts, etc., is dishonoured for want of funds, the drawer would not be deemed to have committed an offence.

(3) The cheque should have been presented to the bank within a period of six months from the date on which it is drawn or within the period of its validity, whichever is earlier.

(4) The payee or the holder in due course of the cheque should have made a demand for the payment of the said amount of money by giving a notice in writing to the drawer of the cheque within 15 days of the receipt of information by him from the bank regarding the return of the cheque unpaid.

(5) The drawer of such cheque should have failed to make the payment of the said amount of money to the payee or the holder in due course of the cheque within 15 days of the receipt of the said notice.

(6) The payee or the holder in due course of the cheque dishonoured should have made a written complaint of the offence to a Court not inferior to that of a metropolitan magistrate or a first class judicial magistrate, within one month of the date on which the cause of action arose under the said provisions.

It has also been provided that it shall be presumed, unless the contrary is proved, that the holder of such cheque received the cheque in the discharge of a liability.

If the person committing an offence under the aforestated provisions is a company, the company itself as well as every person who was in charge of, and was responsible to, the company for the conduct of the business of the company, shall be deemed to be guilty of offence and shall be liable to be proceeded against and punished accordingly. But a person will not be liable in a case where he proves that the offence was committed without his knowledge, or that he had exercised all due diligence to prevent the commission of such offence.

It may be noted that the remedy available to the payee or the holder of a dishonoured cheque under the above provisions is an *additional*

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remedy. He does not lose his right under the civil law to claim the amount due to him in case the cheque accepted by him in payment of such dues is dishonoured. He can either base his claim on the original debt or he can sue the drawer of the cheque for the amount of the cheque.

TEST QUESTIONS

1. What is meant by the term "crossing a cheque?" What are the various types of crossing?

2. What is the effect of crossing a cheque? Who can cross a cheque? What is the difference between general and special crossing?

3. Discuss the law relating to crossed cheques and the protection granted to the collecting banker in respect thereof. Does a paying banker even incur liability in the case of crossed cheques?

4. Indicate the cases in which a banker *(i)* must, *(ii)* may, refuse to honour a customer's cheques.

5. Discuss the law relating to the protection granted to a paying banker with special reference to order and bearer cheques.

6. (*a*) Explain the effect of "Not Negotiable" crossing.

(b) Has the holder of a cheque any rights against the banker? If so, under what circumstances?

7. Discuss the law relating to bouncing of cheques for insufficiency of funds in the accounts.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. A cheque payable to bearer is crossed generally and is marked 'not negotiable.' The cheque is lost and comes into the possession of *B*, who takes it in good faith and for value. *B* deposits the cheque into his own account and his banker collects the same. *(a)* Discuss the liability of collecting banker and paying banker. *(b)* Can *B* be compelled to refund the money to the true owner of the cheque?

[**Hint**. *(a)* Neither the collecting banker nor the paying banker incur any liability to anyone because of special protection granted to the bankers under the Act. *(b)* Yes, the true owner can compel *B* to refund the money because the cheque bears 'not negotiable' crossing as a result of which the transferee cannot get a better title than that of the transferor.]

2. *A*'s wife forged his signature on 40 cheques drawn on *M* bank and cashed them. Upon his discovery of the forgeries, *A* did not at once inform the bank, but some months later when his wife informed him that she wanted more money for the purpose for which the previous cheques had been drawn and cashed by her, he stated his intention of notifying the bank, with the result that the same night his wife committed suicide. *A* brought an action against the bank, claiming to be credited with the amounts of the forged cheques. Will he succeed?

[**Hint**. No, *A* will not succeed as he did not inform the banker at once after coming to know about the forgeries. He is guilty of gross negligence. His continued

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silence operated to prevent the bank from taking its remedies against the wife.]

3. A cheque is drawn payable to '*B* or order.' It is stolen and *B*'s indorsement is forged. The banker pays the cheque in due course. Is the banker discharged from liability? Would it make any difference if the drawer's signatures were forged?

[**Hint.** Yes, the paying banker is discharged from liability, despite the forged indorsement in favour of the payee, because of special protection granted by Section 85(1). Of course, where the drawer's signature is forged, a banker remains liable to the drawer even by a payment in due course and cannot debit the drawer's account.]

4. A banker pays a cheque crossed generally over the counter. Is he liable to the drawer or to the payee of the cheque?

[**Hint.** The banker is liable to the payee of the cheque and not to the drawer (Sec. 129).]

5. *A* draws a cheque payable to 'Self or order'. Before he could encash the cheque, one of his creditors, *B* approaches him for payment. *A* endorses the same cheque in *B*'s favour. The banker refuses payment to *B* on account of insufficiency of funds in the account. Can *A* be made liable to penalties for dishonour of cheque due to insufficiency of funds in the account under Section 138 ?

[**Hint.** No, *A* cannot be made liable to penalties for dishonour of cheque due to insufficiency of funds in the account since the cheque was not originally drawn payable to *another person.* A cheque drawn payable to self and later endorsed in favour of another person does not seem to fall within the purview of the provisions of Section 138 which lays down that the cheque should have been drawn for payment to another person.]

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PART V

Law of Insurance

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Chapter 31

Nature and Principles of Insurance

Definition of Insurance

Insurance may be defined as a cooperative device to spread the loss caused by a particular risk over a number of persons who are exposed to it and who agree to insure themselves against that risk. This means that insurance provides a pool to which the many contribute a certain sum of money called the premium, and out of which the few who suffer losses are compensated by the insurer.[1] By insurance the risk is transferred from the individual to the insurer who takes into account the total likely loss in a certain period, and then fixes the premium to be charged from each person insured. For example, in the case of marine insurance if the total likely loss of ships on voyage on a particular route is estimated to be two ships per year, valued at two crores of rupees, and the total number of ships expected to be on voyage per year is calculated to be, say, 1,000 ships, then the premium for each ship may be fixed at $\frac{2,00,00,000}{1,000}$ = Rs 20,000 + say, Rs 2,000 for other expenses and profits, *i.e.*, Rs 22,000. Thus, it can be seen that insurance is a device by which an insured person can protect himself from the heavy loss likely to be caused by an uncertain event in exchange for paying a comparatively much smaller sum of money as premium.

It may be noted that insurance cannot prevent loss of property or goods by fire or other perils. It can merely provide financial compensation for the effects of misfortune. An insurance, therefore, does not protect the material property which is the subject-matter of the insurance, but the *pecuniary interest* of the insured.

Types of Insurance

The risks which can be insured have increased in number and extent

[1]This is true in the case of marine, fire and accident insurance which cover contingencies, but it does not so fully apply to life insurance where every policy becomes a claim ultimately.

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owing to the growing complexity of the present day economic system. Insurance, thus, occupies an important place in the modern world. It plays a vital role in the life of every citizen and has developed in recent times on an enormous scale leading to the evolution of many different types of insurance. In fact, now-a-days almost any risk can be made the subject-matter of contract of insurance. Even singers can now get their voice insured and dancing girls can get their legs insured, so that when their singing or dancing skill declines, the insurance company pays them the policy amount.

Insurance business is divided into two main branches:

1. Life Insurance[2] business.
2. General Insurance business.

General Insurance business means *fire, marine* or *miscellaneous* insurance business.[3] Items like employers' liability insurance, burglary insurance, fidelity guarantee insurance, livestock insurance, crop insurance, motor vehicles insurance, *etc.*, fall under *Miscellaneous Insurance* business category. We shall be discussing in detail the three most important types of insurance, namely, Life, Fire, and Marine insurance in the succeeding chapters.

Governance of Insurance Business

The insurance business in India is governed by the following Acts:

1. The Insurance Act, 1938 (as amended up-to-date[4])
2. The Life Insurance Corporation Act, 1956.
3. The Marine Insurance Act, 1963.
4. The General Insurance Business (Nationalisation) Act, 1972.

The Insurance Act, 1938 contains provisions regarding matters like definition of insurer and insured, commission payable to agents, licensing of agents, appointment of staff, register of policies and register of claims, powers of the Controller of Insurance, acquisition of surrender value by policy, actuarial report, deposits, investment and loans, valuation of the assets and liabilities, accounts and balance sheet, re-insurance, *etc.* The Act also contains provisions relating to the constitution, management and winding up of insurance companies but since all types of insurance business have been nationalised, these provisions (*i.e.*, regarding constitution, management and winding up of insurance companies) have become redundant.

[2]Orthodox British writers applied the term 'assurance' to life assurance and 'insurance' to other classes of insurance. But in current insurance literature, the terms *Assurance* and *Insurance* are interchangeably used.

[3]Sec. 3 (*g*), The General Insurance Business (Nationalisation), Act, 1972.

[4]This Act has been amended for more than a dozen times so far.

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The provisions of the Insurance Act, 1938 are applicable to both Life and General Insurance business insofar as these are not inconsistent with those contained in the special Acts governing them. In addition to this Act *(i)* life insurance business is also governed by the Life Insurance Corporation Act, 1956, (*ii*) fire insurance business is also governed by the General Insurance Business (Nationalisation) Act, 1972, and (*iii*) marine insurance business is also governed by the Marine Insurance Act, 1963, and the General Insurance Business (Nationalisation) Act, 1972.

Nationalisation of Insurance Business

All types of insurance business in India have been nationalised. The Life Insurance business was nationalised in 1956. Since 1st September 1956, life insurance business is carried on exclusively by the Life Insurance Corporation of India (LICI), formed and regulated by the Life Insurance Corporation Act, 1956. The General Insurance business has been nationalized through the General Insurance Business (Nationalisation) Act, 1972. From 1st January 1974, General Insurance Business is transacted only by the General Insurance Corporation of India (GICI), formed in accordance with the aforementioned Act, and its four subsidiary companies, *viz.*, (*i*) National Insurance Co. Ltd., Calcutta, (*ii*) The New India Assurance Co. Ltd., Bombay, (*iii*) The Oriental Fire and General Insurance Co. Ltd., New Delhi, and (*iv*) The United India Fire and General Insurance Company Ltd., Madras.

Exemptions. Section 36 of the General Insurance Business (Nationalisation) Act, 1972, provides exemptions in favour of (*i*) Calcutta Hospital and Nursing Home Benefits Association Ltd., (*ii*) Export Credit and Guarantee Corporation Ltd., and (*iii*) Deposit Insurance Corporation (established under the Deposit Insurance Corporation Act, 1961) which can also carry on the general insurance business in addition to the General Insurance Corporation of India and its four subsidiaries (mentioned above).

Definition of a Contract of Insurance

A contract of insurance is a contract whereby one party undertakes, in return of a consideration called premium, to pay to the other party a certain sum of money on the happening of a certain event (death or attainment of a certain age) or to indemnify the other party against a loss arising from the risk insured (in case of property). The party which promises to pay a certain sum of money to, or to indemnify, the other party is called the *Insurer* [sometimes called as *assurer* (in case of life insurance) or *underwriter* (in case of marine insurance)], and the party to whom this protection is given in exchange of premium is called the *Insured* (or assured).

The document containing the terms and conditions of the contract of

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insurance is called a *Policy*; and the insured is, therefore, called a *Policy-holder*. The consideration which the insured has to pay to the insurer for the protection given to him is called *Premium*. The amount for which a policy is issued is known as the *Insured Amount* or *Policy Amount*. The thing or property insured is called the *subject-matter* of insurance, and the interest of the insured in the subject-matter is called his *insurable interest*.

Nature of a Contract of Insurance

A contract of insurance is a type of contingent contract and is a perfectly valid contract. A contingent contract is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen (Sec. 31 of the Indian Contract Act). Thus where *A* agrees to pay *B* Rs 50,000, in exchange of *B*'s paying Rs 1,000 as premium, if *B*'s house is burnt, there is a contingent contract the performance of which depends upon the happening of an uncertain event. Although a contract of insurance resembles to some extent to a wagering or gambling agreement, the insurer betting with the insured that his house will not be burnt and giving him the odds of its value against the premium, but in reality it is not a wagering agreement[5] for the following reasons:

1. In an insurance contract, the object is to protect the insured against losses on the happening of some uncertain future event. In a wagering agreement, the object is to gamble for money and money only. Thus where *A* contracts with *B* that if it rains today he will pay Rs 100 to *B* and if it does not rain *B* will pay Rs 100 to him, there is a wagering agreement.

2. In an insurance contract, the insured has an insurable interest in the life or property sought to be insured. In a wagering agreement neither party has any pecuniary or insurable interest in the subject-matter of the agreement except the resulting gain or loss. This is the main distinguishing feature of a valid contingent contract as compared to a wagering agreement. If either party has any insurable interest, *i.e.*, proprietary interest in the contract, it will not be a wager.

3. A contract of insurance (except life, accident and sickness insurances) is based on the principle of indemnity. But in a wagering agreement there is no question of indemnity as it does not cover any risk.

4. A contract of insurance is based on scientific calculation of risks and the amount of premium is ascertained after taking into account the various factors affecting the risk. In a wager there is no question of any calculation whatsoever, it being a mere gamble.

Thus, a contract of insurance, being a contingent contract, is an abso-

[5]Wagering agreements have been declared *void ab-initio* under Section 30 of the Indian Contract Act.

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lutely valid contract. The general principles of the law of contract apply equally to such a contract. As such to be a valid contract it must fulfil the following requirements: (*i*) there must be an agreement between the parties, (*ii*) the agreement must be supported by consideration, (*iii*) the parties must be capable of contracting, (*iv*) the consent of the parties to the agreement must be 'free consent', and (*v*) the object must not be illegal or immoral.

Fundamental Principles of Insurance Contracts.

There are certain fundamental principles (or characteristics) more or less[6] common to all classes of insurance business. These are enumerated below:

1. Utmost good faith. The general rule of 'caveat emptor' (let the buyer beware), which applies to ordinary trade contracts, does not apply to insurance contracts. Insurance contracts are contracts of utmost good faith or contracts *uberrimae fidei.* Accordingly, it is the inherent duty of both parties to a contract of insurance to make full and fair disclosure of all *material facts* relating to the subject-matter of the proposed insurance. It is so because insurance shifts risk from one party to another. A material fact for this purpose is a fact which would affect the judgment of a prudent insurer in considering whether he would enter into a contract at all or enter into it at one premium rate or another. For example, in life insurance suffering from a disease like asthma or diabetes is a material fact whereas having occasionally a headache is not a material fact.

Although the duty of utmost good faith applies also to the insurer, for example, he must not urge the proposer to affect the insurance which he knows is not legal or has run off safely, but this duty rests highly on the insured because he knows or is expected to know more about the subject-matter. The proposer must disclose all material facts truly and fully. There should not be any false statement or half truths or any silence on a material fact. This applies to all material facts whether considered by him as material or not and whether known to him or not. The proposer is expected to know every circumstance which in the ordinary course of business ought to be known by him. He cannot rely on his own inefficiency or neglect.

The duty to make a full and true disclosure continues till the contract is concluded, *i.e.*, till the proposal of the insured is accepted by the insurer, whether the policy be then issued or not (*All India General Insurance Company* vs *Maheshwari*[7]), and it is not a continuing obligation. Thus, any material fact coming to the knowledge after the conclusion of the contract need not be disclosed. But the duty to disclose revives with every renewal

[6]The principles of 'indemnity,' 'subrogation' and 'contribution' do not apply to Life Insurance Contracts.

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[7]A.I.R. (1960), Mad. 484.

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of the old policy or alterations in the existing policy.

In case of life insurance, Section 45 of the Insurance Act makes an important provision in this connection. The Section lays down that no policy of life insurance, shall, after the expiry of two years from the date on which it was effected, be called in question by an insurer on the ground that the statement made was inaccurate or false, unless the insurer shows that such statement was on a material matter or suppressed facts which it was material to disclose and that it was fraudulently made by the policy-holder.

Exceptions. The following types of facts are not required to be disclosed by the proposer, *i.e.*, the non-disclosure of them shall not be fatal to the contract:

(*i*) Any fact which diminishes the risk.

(*ii*) Any fact which is known or presumed to be known to the insurer.

(*iii*) Any fact which is of the nature of public knowledge or which relate to the law of the country.

(*iv*) Any fact as to which information is waived by the insurer.

Consequences of breach. If the utmost good faith is not observed by either party, the contract becomes voidable at the option of the party not at fault, irrespective of whether the non-disclosure was intentional or innocent. Of course in case of innocent misrepresentation the premium is refundable on the avoidance of the contract.

2. **Indemnity.** The second fundamental principle is that all contracts of insurance are contracts of indemnity, except those of life and personal accident insurances where no money payment can indemnify for loss of life or bodily injury. In case of marine and fire insurances the insurer undertakes to indemnify the insured for loss or damage resulting from specified perils. In case of loss the insured can recover from the insurer the actual amount of loss, not exceeding the amount of policy. If there is no loss under the policy, the insurer is under no obligation to indemnify the insured. The object of indemnity is to place the insured after a loss in the same position as he occupied immediately before the event. Under no circumstances the insured is allowed to benefit more than the loss suffered by him. This is because, if that were so, the temptation would always be present to desire the insured event and thus to obtain the policy proceeds. This would obviously be contrary to the public interest.

Even contracts of fire or marine insurance cease to be contracts of indemnity when they provide for the payment of a fixed sum of money in the event of total loss or destruction by the peril insured against, without demanding any further proof of actual loss. This is so in the case of 'valued policies'. Of course in such policies as well, if partial loss is there then the insured is only indemnified, because no body is allowed to make a profit of his loss.

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It may also be mentioned that indemnity is linked with 'insurable interest.' If an one-fourth co-owner gets the full property insured, he shall be indemnified to the extent of his interest or share only in the case of total destruction of the property insured.

3. **Insurable interest.** 'Insurable interest' is an essential pre-requisite in effecting a contract of insurance. The insured must possess an *insurable interest* in the subject-matter of the insurance *at the time of contract*[8], otherwise the contract of insurance will be a wagering agreement which shall be void and unenforceable.

Insurable interest means some proprietory or pecuniary interest. The object of insurance is to protect the pecuniary interest of the insured in the subject-matter of the insurance and not the material property as such. A person is said to have an insurable interest in the subject-matter insured where he will derive pecuniary benefit from its existence or will suffer pecuniary loss from its destruction. Insurable interest is thus a financial interest in the preservation of the subject-matter of insurance. A purely sentimental interest or a non-monetary benefit will not cause an insurable interest. Accordingly, a creditor has an insurable interest in the life of the debtor but a son has no insurable interest in the life of his mother who is supported by him. To take the case of fire or marine insurance, it is not the owner alone, but all those persons have insurable interest who run a risk, have something at stake or something to lose by the loss or damage to the property or goods insured. For example, a person who has advanced money on the security of a house has an insurable interest in the house. Similarly, a pledgee has an insurable interest in the goods pledged. The charterer of a ship has insurable interest in the ship because he runs a risk of losing his freight if the ship is lost or damaged.

In the case of *Life Insurance,* insurable interest must be present only at the time of contract (*i.e.*, when the insurance is effected). It need not be there at the time of death or when the claim is made because it is not a contract of indemnity. Thus a life insurance policy is freely assignable.

In the case of *Fire Insurance,* insurable interest must be present both at the time when the insurance is effected and at the time of loss. Being a contract of indemnity, a fire insurance policy can be assigned only to one who has acquired some interest in the subject-matter as a purchaser, mortgagee or pledgee because unless the assignee has interest at the time of loss, he cannot be indemnified.

[8]In the case of marine insurance, it is not essential for the assured to have an insurable interest at the time of effecting the insurance but he must have insurable interest at the time of loss of the subject-matter insured (Sec. 8 of the Marine Insurance Act, 1963).

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In the case of *Marine Insurance,* insurable interest must be present at the time of the loss of subject-matter and it is not essential for the assured to have an insurable interest at the time of effecting the insurance.

4. **Causa proxima.** The next principle of insurance is that the insurer is liable only for those losses which have been proximately caused by the peril insured against. In other words, in order to make the insurer liable for a loss, the nearest or immediate or last cause is to be looked into, and if it is the peril insured against, the insured can recover. This is the rule of *causa proxima.* Insurers are not liable for remote causes and remote consequences even if they belong to the category of insured perils. "The question, which is the *causa proxima* of a loss, can only arise where there has been a succession of causes. When a result has been brought about by two causes, you must, in insurance law, look to the nearest cause, although the result would, no doubt, not have happened without the remote cause... The law will not allow the assured to go back in the succession of causes to find out what is the original cause of loss" (*Pink* vs *Fleming*[9]).

ILLUSTRATIONS. (*a*) In a marine policy, the cargo was a shipment of oranges. The peril insured against was collision with another ship. During the course of voyage the ship actually collided, resulting in delay and mishandling of shipment which made oranges unfit for human consumption. It was *held* that the loss was due to mishandling and delay and not due to collision, which was a remote cause, though without it no mishandling or delay was necessary. As such the insurer was not held liable (*Pink* vs *Fleming*[10]). (For mishandling the crew and their principal could be made liable but not the insurer).

(*b*) In a marine policy, the goods were insured against damage by sea-water. Some rats on board bored a hole in a zinc pipe in the bath which caused sea-water to pour out and damage the goods. The underwriters contended that as they had not insured against the damage by rats, they were not bound to pay. It was *held* that the proximate cause of damage being sea-water the insured was entitled to damages, the rats being a remote cause (*Hamilton* vs *Pandrof*[11]).

Thus, in deciding whether the loss has arisen through any of the risks insured against, the proximate or the last of the causes is to be looked into and others rejected. If loss is caused by the operation of more than one peril simultaneously and if one of the perils is an excepted (*i.e.*, uninsured) peril, the insurer shall be liable to the extent of the effects of insured peril if it can be separately ascertained. The insurer shall not be liable at all if the effects of insured peril and excepted peril cannot be separated.

It may be added that although the principle of *causa proxima* applies mostly in the case of marine and fire insurances, it is applicable in the life

[9](1899), 25 Q.B.D. 396.
[10](1899), 25 Q.B.D. 396.
[11](1887), 12 App. Cas. 518.

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insurance as well because in 'personal accident policies' the proximate cause of the death should be accident. In case of natural death the insurer is not liable thereon.

5. **Risk must attach.** The next principle of insurance is that for a valid contract of insurance the risk must attach. If the subject-matter of insurance ceases to exist (*e.g.*, the goods are burnt) or the insured ship has already arrived safely, at the time the policy is effected, the risk does not attach, and as a consequence, the premium paid can be recovered from the insurers because the consideration for the premium has totally failed. Thus, where the risk is never run, the consideration fails and therefore the premium is returnable. It being a general principle of law of insurance that 'if the insurers have never been on the risk, they cannot be said to have earned the premium.'

The risk also does not attach and therefore the premium is returnable where a policy is declared to be void *ab-initio* on account of some defect, *e.g.*, assured being minor or parties not being ad-idem. But where a policy is void because there is no 'insurable interest', premium paid cannot be recovered because in that case it amounts to 'wager,' except in the case of marine insurance where the assured is not required to have insurable interest at the time of entering into the contract (*Harse* vs *Pearl Life Assurance Co.*). Also, the premium cannot be recovered where the policy is avoided by the insurer on grounds of fraud by the insured.

6. **Mitigation of loss.** When the event insured against occurs, for example, in the case of a fire insurance policy when the fire occurs, it is the duty of the policy-holder to take steps to mitigate or minimise the loss as if he were uninsured and must do his best for safeguarding the remaining property, otherwise the insurer can avoid the payment of loss attributable to his negligence. Of course, the insured is entitled to claim compensation for the loss suffered by him in taking such steps from the insurer.

7. **Doctrine of subrogation.** The doctrine of subrogation is a corollary to the principle of indemnity and as such applies only to fire and marine insurances. According to the principle of indemnity the insured can recover only the actual amount of loss caused by the peril insured against and cannot be allowed to benefit more than the loss suffered by him. In case the loss to the property insured has arisen by chance without any fault on anybody's part, the insured can make the claim against the insurer only. In case the loss has arisen out of tort or mischief by some third party, the insured becomes entitled to proceed against both the insurer as well as the wrongdoer. But since a contract of insurance is a contract of indemnity, the insured cannot be allowed to recover from both and thereby make a profit from his insurance claim. He can make a claim against either the insurer or the wrongdoer. If the insured elects to be indemnified by the insurer, the

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doctrine of subrogation comes into play and as a result the insurer shall be subrogated to all the rights and remedies of the insured against third parties in respect of the property destroyed or damaged.

Lord Cairns, in *Simpson* vs *Thomson*[12] defined subrogation thus: "a right founded on the well known principle of law that where one person has agreed to indemnify another he will, on making good the indemnity, be entitled to succeed to all the ways and means by which the person indemnified might have protected himself against or reimbursed himself for the loss." According to the doctrine of subrogation, the insurer, after indemnifying the insured for his loss *in full*, steps into the shoes of the insured and is subrogated to all the alternative rights and remedies which the insured has against the third persons, until he (the insurer) recoups the amount he had paid under the policy. In case something more is recovered under subrogation rights, the excess shall belong to the policy-holder because the insurer is entitled to the assured rights in respect of the subject-matter insured, insofar as he has indemnified the assured (*Attorney General* vs *Glen Line Ltd.*[13]).

The following points are worth noting in connection with the doctrine of subrogation:

1. This doctrine will not apply until the assured has recovered a *full indemnity* in respect of his loss from the insurer. If the amount of the insurance claim is less than actual loss suffered, the assured can keep the compensation amount received from any third party with himself to the extent of deficiency, and if after full indemnification there remains some surplus he will hold it in trust for the insurer, to the extent the insurer has paid under the policy.

2. The insured should provide all such facilities to the insurer which may be required by the insurer for enforcing his rights against third parties. Any action taken by the insurer is generally in the name of the insured, but the cost is to be borne by the insurer.

3. The insurer gets only such rights which are available to the insured. He gets no superior rights than the assured. As such the insurer can recover under this doctrine, only that which the assured could himself have recovered.

ILLUSTRATION. *R* owned two ships, *A* and *B* and got them insured with different insurers. The ships collided due to the fault of the crew of the ship *B*, as a consequence of which ship *A* was damaged. The insurers of the ship *A* indemnified the owner and then sued him as owner of the ship *B* for negligence, claiming the amount they had paid in respect of the ship *A*. *Held*, the insurers could not

[12](1877), 3 App. Cas. 279.
[13] (1930), 46, T.L.R. 451.

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recover, as both vessels were owned by one and the same person, no remedy has been transferred to the insurers, because a person cannot file a suit against himself (*Simpson* vs *Thomson*[14]).

8. **Doctrine of contribution**. Like the doctrine of subrogation, the doctrine of contribution also applies only to contracts of indemnity, *i.e.*, to fire and marine insurances. The doctrine of contribution states that 'in case of double insurance[15] all insurers must share the burden of payment in proportion to the amount assured by each. If an insurer pays more than his rateable proportion of the loss, he has a right to recover the excess from his co-insurers, who have paid less than their rateable proportion.' Thus, the essential conditions required for the application of the doctrine of contribution are:

1. There must be double insurance, *i.e.*, there must be more than one policy from different insurers covering the same interest, the same subject-matter and the same peril which has caused the loss.

2. There must be either over-insurance[16] or only partial loss. If the amount of different policies is just equal to the value of the subject-matter destroyed, the different insurers are liable to contribute towards the loss upto the full amount of their respective policies and as such the question of contribution as between themselves does not arise.

3. The assured must recover the whole of his loss from one or more of the insurers, and not from all the concerned insurers in proportion to the amount assured by each.

If all the above conditions are fulfilled then the doctrine of contribution

[14](1877), 3 App. Cas. 279.

[15]When the *same risk* and the *same subject-matter* is insured with more than one insurer, there is said to be '*double insurance*'. If two different policies are taken from one and the same insurer, it is not a case of double insurance. It will be termed as 'full insurance.' Under double insurance the same risk and the same subject-matter must be insured with two or more *different* insurers. In the event of loss under double insurance, the assured may claim payment from the insurers in such order as he thinks fit, but he cannot recover more than the full amount of the actual loss, subject to the insured sum, as a contract of insurance is a contract of indemnity.

[16]When the amount, for which the property has been insured, is more than the real value of the property, it is called as '*over-insurance.*' Accordingly, in the case of double insurance, there is over-insurance if the amount of different policies exceeds the actual value of the property insured. Over-insurance is not of any advantage in case of fire and marine insurances as they are basically contracts of indemnity and the assured can never recover more than the actual loss suffered by him. Of course, the problem of over-insurance does not arise in the case of life insurance, because human life is priceless.

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comes into operation which enables the Insurer, who pays more than his rateable proportion of loss (because he meets the whole claim), to enforce proportionate contribution from the other insurers.

ILLUSTRATION. A building is insured against fire for Rs 20,000 with insurer *X* and for Rs 10,000 with insurer *Y*. There occurs a fire and the damage is estimated at Rs 15,000. *X* and *Y* should share the loss in proportion to the amount assured by each of them, *i.e.*, in the proportion of 2:1. *X* should pay Rs 10,000 and *Y* should pay Rs 5,000. The policy-holder can sue both the insurers together or insurer *X* only. Suppose that he sues *X* only and recovers from him the full amount of loss, *i.e.*, Rs 15,000, *X* is entitled to claim contribution from *Y* to the extent of Rs 5,000.

9. **Terms of policy.** A contract of fire insurance is for a fixed duration, usually for one year, and the liability of the insurer automatically comes to an end on the expiry of the period. A contract of marine insurance may be either for a certain period or for a particular voyage. If it is for a certain period, the liability of the insurer comes to an end after the expiry of that period even if the voyage has not yet ended. And if it is for a particular voyage, then the liability of the insurer continues till the voyage has ended even if it takes longer than a year. A contract of life insurance is not a contract for a year only, but is a continuing contract and covers either a specified number of years or the balance of the insured's life. As a contract of life insurance covers a continuing risk, advance payment of premium every year[17] during the whole term of policy is a condition precedent for keeping the policy in force and if the premium due is not paid within the due time plus the grace period, the policy lapses.

Reinsurance

An insurer assuming larger risk from the direct insurance business may arrange with another insurer to offload the excess of the undertaken risk over his retention capacity. Such arrangement between two insurers is termed 'reinsurance'. Thus, by the device of reinsurance the original insurer transfers a part of the risk to the reinsurer. Payment made by the ceding insurer (called original insurer or *reinsured*) to accepting insurer (called reinsurer) for the assumption of the risk by the latter is termed 'reinsurance premium'.

A reinsurance contract does not affect the original insurer's contractual obligation to the insured under the original contract of insurance. Moreover, in the absence of any privity of contract between the reinsurer and the originally insured person, the latter cannot have any remedy against the

[17]Life insurance premiums may be paid annually in one lump sum or in instalments which may be half-yearly, quarterly or monthly at the option of the assured.

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former. It is worth noting that since a contract of reinsurance is also a contract of indemnity, the reinsurer, before paying the money, must make sure that the sum originally insured has been paid by the 'original insurer' (or the 're-insured'). Of course, after paying the money in proportion to the risk transferred to him, a reinsurer becomes entitled to the benefits of subrogation.

If for any reason, the original policy lapses, the reinsurance comes to an end. Further, if the original contract is altered without the consent of the reinsurers, the reinsurers are discharged. Hence a policy of reinsurance is co-extensive with the original policy.

TEST QUESTIONS

1. Define the term 'insurance.' Mention the principal branches of insurance business. Enumerate the different Acts which govern the insurance business in India.

2. Define a contract of insurance. Explain its nature.

3. Explain what is meant by a contract of insurance and how does it differ from an agreement by way of wager?

4. Explain and illustrate the fundamental principles of insurance.

5. (*a*) 'A contract of insurance is a contract *uberrimae fidei*'. Explain.

(*b*) What is meant by insurable interest? When must it subsist in the case of fire, marine and life insurance contracts?

6. Discuss the doctrine of subrogation and the doctrine of contribution in relation to fire and marine insurances.

7. What is a contract of insurance? What is its nature? Explain the fundamental principles of insurance.

8. Write short notes on: (*i*) Double Insurance, (*ii*) Over Insurance, and (*iii*) Reinsurance.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *B* effected an insurance on his goods against loss or damage by fire. *B* and his wife quarrelled and the excited wife set fire to and destroyed the goods. Can *B* recover under the policy ? If yes, can the insurer sue the wife under the doctrine of subrogation?

[**Hint**. Yes, *B* can recover under the policy as the wife had set fire to the goods without his connivance. But the insurer cannot sue the wife under the principle of subrogation because there can be no subrogation of those rights which the insured himself does not have (the husband himself cannot sue his wife for her tort). (*Midland Insurance Co.* vs Smith)]

2. *P* contracted to build a stop for *R* for Rs 25,000. All the materials were to be supplied by *R*. Can *P* get the materials insured for the period of construction?

[**Hint**. Yes, *P* can get the materials insured because he has insurable interest

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therein as he would suffer financial loss on the destruction of the material.]

3. *A*'s goods in a warehouse are insured against loss by fire. *B* is the insurer. The goods are destroyed by fire. *A* recovers their full value of Rs 10,000 from *B*. Then *A* sues the warehouse-keeper and recovers Rs 10,000 from him. *B* claims this amount from *A* but *A* refuses to hand over the amount to *B*. Can *B* recover the amount from *A*?

[**Hint**. Yes, *B* can recover the amount of Rs 10,000 from *A* because *A* has already made good his loss from *B* and the amount which he received from the warehouse-keeper makes his receipt in excess of the loss actually suffered by him. A contract of fire insurance being a contract of indemnity, the insured person cannot be allowed to make a profit of his loss.]

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Chapter 32

Life Insurance

The life insurance business is governed by the Insurance Act, 1938 (as amended up-to-date) and the Life Insurance Corporation Act, 1956. The latter Act was passed to provide for the nationalisation[1] of life insurance business in India by transferring all such business to the Life Insurance Corporation of India (LICI) established for the purpose, and to provide for the rules and regulations relating to the working of LICI, *i.e.,* relating to its administration, deposits and investment of funds, finance, accounts and audit, *etc.*

Since 1st September 1956, life insurance business is carried on exclusively[2] by the Life Insurance Corporation of India, formed and governed by the Life Insurance Corporation Act, 1956.

Definition of a Contract of Life Insurance

A contract of life insurance is a contract whereby the insurer, in consideration of a certain premium, undertakes to pay to the assured, or to the nominee/assignee or the legal successor (as the case may be) of the assured in case of his death, a stated sum of money or annuity (*i.e.,* payment in monthly, quarterly, half-yearly or yearly instalments), on the death of the insured (the person whose life is insured) or on the expiry of a certain period, whichever is earlier, in case of an Endowment Policy, and on the

[1]As the first step towards nationalisation of life insurance in India, the Life Insurance (Emergency Provisions) Ordinance was promulgated on 19 January 1956, which vested in the Central Government, with immediate effect, the management of life insurance business in India of Indian and foreign insurers and the foreign life insurance business of Indian insurers. Later on the Life Insurance Corporation Act was passed on 18 June 1956, which came into force on 1st July 1956. By this Act the Life Insurance Corporation of India was set up, which began its functioning on 1st September 1956, and to which all the assets and liabilities pretaining to life insurance business of existing insurance companies were transferred.

[2]Under Section 44 of the Life Insurance Corporation Act, 1956, some types of life insurance business (particularly post office life insurance business) have been excluded from the purview of the Corporation.

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death of the insured, under a Whole Life Policy.

According to Section 2 (11) of the Insurance Act, 1938, 'life insurance business' means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only) or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include:

(a) the granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance;

(b) the granting of annuities upon human life; and

(c) the granting of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade or employment or of the dependents of such persons.

Difference between Life Insurance and other Forms of Insurance

Life insurance differs fundamentally from other forms (fire and marine *etc.*) of insurance in the following respects:

1. **Subject-matter.** In life insurance the subject-matter of insurance is human life, whereas in other forms of insurance the subject-matter of insurance is goods or property.

2. **Certainty of event.** In life insurance, the event insured, namely, death is bound to happen, the only uncertainty being as to the actual time of its occurrence. But in the case of fire, marine, or accident insurance, the event insured against may or may not happen at all.

3. **Indemnity.** The life insurance contract is a valued contract, whereas any other form of insurance contract is a contract of indemnity. In life insurance, a fixed sum (*i.e.*, the policy amount) is paid without any proof of loss (for the loss resulting from death cannot be estimated in money), but in non-life insurance, the amount of actual loss not exceeding the policy amount is paid. Life insurance is effected as a means of protection for the dependents and saving, the idea of indemnity is foreign to it.

4. **Time of insurable interest.** In a contract of life insurance the assured must have an insurable interest at the time of effecting the policy. In fire insurance, the insured must have an insurable interest both at the time when the policy is effected, and at the time of loss. In marine insurance, the insurable interest must exist at the time of the loss and it is not essential for the insured to have an insurable interest at the time of effecting the insurance.

5. **Duration of contract.** A life insurance contract is a long-term contract, *e.g.*, 10 years, 20 years, 30 years, but a non-life insurance contract is entered into for year to year.

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Insurable Interest

'No insurable interest — no insurance' is a maxim of the law of insurance. Thus, a contract of life insurance is void unless the assured has an insurable interest in the life insured. Insurable interest arises out of the pecuniary relationship that exists between the assured (*i.e.*, the policy-holder) and the life insured, so that the policy-holder stands to lose by the death of the insured and continue to gain by his remaining alive. In other words, one can have an insurable interest only when he would stand to benefit financially by the continued existence of the person whose life is insured, or when the would be put to a financial loss by the death of the insured person. Insurable interest is thus a financial or pecuniary interest in the preservation of the life to be insured. Mere ties of blood and affection, howsoever strong, do not give rise to insurable interest. Thus, a son has no insurable interest in the life of his father who is a pauper and is supported by the son.

In life insurance, the assured must have insurable interest in the life upon which insurance is effected at the time when the contract of insurance is entered into. It need not be present at the time of the death of the person insured or when the policy falls due. The reason for this rule is that a contract of life insurance is not a contract of indemnity.

Presumption of insurable interest. In the following three cases, insurable interest is presumed to exist and no proof is required:

(a) In own's life. In this case interest is presumed because one can protect his estate from that loss of his future gains or savings which might be the result of his premature death.

(B) Wife in the life of her husband. In this case interest is presumed because the husband is legally bound to support his wife and hence she has insurable interest in the life of her husband.

(c) Husband in the life of her wife. In this case interest is presumed only if the wife is literate and earning member.

In these cases there is no limit to the amount of insurable interest *(i.e.,* interest is presumed upto an unlimited extent) and one can insure for any sum whatsoever, and as often as he pleases. However, in practice the sum assured is restricted by the assured's financial status and capacity to pay the premium.

No presumption of insurable interest. The cases where insurable interest is not presumed and an evidence of interest is required can be studied under two heads: *(i)* persons related, and *(ii)* persons not related.

(i) Persons related. In case of relations other than husband and wife, *e.g.*, father and son, uncle and nephew, sister and brother, insurable interest is to be proved. If one proves that he is supported by another relation then only he can insure that other relation's life. Thus, a father has no insurable

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interest in the life of his own unless he proves that he is dependent on the son. Similarly, a son has no insurable interest in the life of the mother who is supported by him. A widow sister has an insurable interest in the life of her brother who supports her.

In such relationships where pecuniary interest is proved there is no limit as regards the amount of insurance. But usually assured's ability to pay premium decides the amount of insurance policy.

(ii) Persons not related. The following have been held to have an insurable interest due to business or contractual relationship:

(a) A creditor in the life of his debtor 'to the extent of the debt'.

(b) A creditor in the life of a surety, and the surety in the life of his principal debtor and of his co-surety, to the extent of his guarantee.

(c) A partner (in a firm) in the life of a co-partner to the extent of the capital invested by the latter, because in case of the death of a co-partner his share of capital will have to be paid to his heirs as a result of which there may be shortage of funds causing great financial loss to the partner(s).

(d) An employee in the life of his employer, upto wages or salary for the term of service contracted for.

(e) An employer in the life of his key employee, *e.g.,* the general manager or the chief engineer, upto the likely loss of profits to the employer because of loss of skill and knowledge of such an employee until a man of equal calibre and experience is found out.

It is to be noted that in the above cases the assured has a limited interest, in the life of the another upon which insurance is effected, to the extent of possible financial loss by the demise of such another person, and he can insure only for a sum *not exceeding his interest* in the life of the another. It may further be noted that in these cases the full amount of insurance is payable irrespective of the fact that the assured has no insurable interest in the life of the insured at the time of making the claim. It is so because life insurance is not a contract of indemnity. Thus, if the life of a debtor has been insured and the debtor repays the debt in due course, the assured can recover the amount of the policy on the death of the debtor in spite of the fact that he has no insurable interest in the debtor's life at the time of his death as the debt has been already repaid.

Procedure for Effecting a Life Policy

Any person who has attained majority and who can enter into a valid contract can take out a life insurance policy on self and on those in whom he has *insurable interest.* Policies can be taken out, subject to certain conditions, on the life of one's spouse or child. Proposals on the lives of women, either with earned income or with unearned income attracting Income-tax or having wealth which attracts Wealth-tax, are treated on par

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with male lives. In other cases, an extra premium is charged.

A person desiring to take out a policy of life insurance has to fill in a *Proposal Form* supplied by the insurer (*i.e.,* the Life Insurance Corporation of India). There are different types of proposal forms for each type of policy. The proposal form requires information with regard to the health of the proposer, his family history, his age, habits of life, the amount, kind and term of policy. The proposer should answer all the questions in the good faith. He must disclose all the material facts truly and fully. The proposer is also required to undergo a medical examination.[3] The proposal form is accompanied by the first premium amount and if the insurer accepts the same unconditionally and issues the First Premium Receipt (which acts as the acceptance letter), there comes into existence a binding contract and the risk commences from the date of issuing the Receipt. In due course the insurer issues the *Insurance Policy* which evidences the contract of insurance which has already been made between the insured and the insurer. In the Policy the contract is completely expressed. The terms and conditions of the policy can be altered during it currency by the mutual consent of the parties.

The *proposal form* is the basis of the contract of insurance. Life insurance being a contract *'uberrimae fidei', i.e.,* of utmost good faith, if any statement in the proposal form is false, or there is concealment of material facts, the insurer can avoid the policy. Of course, in case of innocent misrepresentation the premium is returnable on the avoidance of the policy.

Check on the power of insurer to avoid policy. Section 45 of the Insurance Act, 1938 makes an important provision in this connection and places a check on the power of insurer to avoid life policy on the ground of innocent misrepresentation after the expiry of two years of the policy term. The Section provides that no policy of life insurance shall be called in question by the insurer after two years from the date on which it was effected on the ground that a statement made in the proposal for insurance, or in any report of a medical officer, or referee, or friend of the insured, or in any other document leading to the issue of the policy, was inaccurate or false, unless the insurer shows that such statement was on a material matter or suppressed facts which it was material to disclose and that it was fraudulently made by the policy-holder. Of course, this does not prevent the insurer from calling for proof of age at any time if entitled to do so.

[3] No medical examination is, however, required *(i)* if the proposer is a government or semi-government employee and the policy amount does not exceed Rs 10,000, and *(ii)* if the proposer is not a government or semi-government employee and the policy amount does not exceed Rs 5,000.

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Kinds of Life Insurance Policies

Various types of policies are issued to meet the varying needs of the members of the society. The more important types are:

1. **Whole life policy.** Under this policy the premiums are payable throughout the life of the assured. The sum assured becomes payable only on the death of the assured to his assignees, or nominees or heirs. The premium charged under this policy is the lowest.

2. Endowment policy. In this case, the policy runs only for a limited period or up to a particular age not exceeding the age of 70 years. Premiums are payable till the maturity of the policy. The sum assured becomes payable *either* after a specified number of years, *or* on the death of the assured, whichever is earlier. The premium rate in this policy is much higher than that of the whole life policy. This type of policy is most popular because it combines the advantage of savings for old age with that of protection of the assured's family in the event of his premature death.

3. Limited payment life policy. In this case, premiums are payable for a specified number of years (*i.e.,* upto the assured attaining a certain age, *e.g.,* 60 years) or until death if it occurs earlier, but the sum assured becomes payable only on the death of the assured. This policy resembles partly to endowment policy (as the premiums are payable for a fixed term after which the obligation to pay premium ceases), and partly to whole life policy (as the policy amount becomes payable only on the death of the assured).

4. Convertible whole life policy. In case of such a policy the premium is low at the beginning, treating the policy as a whole life policy. Under the terms of the policy the assured is given an option to convert the policy into an endowment policy after five years. If option is not exercised, it continues as a whole life policy, with premium ceasing at a certain age. This type of policy is good for youngmen who are at the threshold of their career.

5. **Joint life policy.** This type of policy is taken upon the joint lives of two or more persons. The sum assured becomes payable at the end of a specified term of years, or on the first death of either of the lives assured, whichever is earlier, to the survivor(s). This type of policy is particularly useful for partners in a partnership firm, where the death of one partner can have serious financial repercussions for the other partners.

6. **Annuity policy.** This policy is an endowment policy with the difference that here the full amount of the policy is not payable in a lump sum but is payable in the form of annuities (fixed periodical payments) for a specified number of years or till the death of the assured. This policy is good for providing regular income.

7. **Education/Marriage endowment policy.** Such a policy is effected

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for the purpose of meeting the education or marriage expenses of children. As is usual, here also the assured insures his own life but the purpose is different. Such a policy is always for a specified period. The premiums are payable for the selected term of years or until death of the policy-holder if it occurs earlier within that period. The sum assured is payable only after the expiry of the fixed term even if the policy-holder dies earlier. It is important to note that after the expiry of that stipulated term the claim is payable even if the child also dies before that date. In the case of Education Endowment policy, the policy amount is payable for a period of five years in half yearly instalments. In the case of Marriage Endowment policy, the whole amount is payable in a lump sum. The purpose of this type of policy is to ensure the education or marriage of children, even in case of premature death of father.

Besides, the "Children's deferred endowment assurance policy," and the "Children's anticipated policy" are other good plans of assurance to provide for the child at a much lower rate of premium.

'With profits' or 'without profits' policies. The different types of policies discussed above may be either *(i)* with profits,[4] or *(ii)* without profits. A policy-holder who holds 'with profits' policy shares in the profits of the insurance company (*i.e.,* the LICI) and gets the accumulated profits, credited to his policy as bonus every year, in addition to the sum assured, on the maturity of the policy. A holder of policy 'without profits' does not share in the profits of the insurance company. The premium for the 'with profits' policy is higher than that of the 'without profits' policy.

With a view to satisfying the needs of the insuring public in the changing times, the Life Insurance Corporation has brought out some new types of policies. The more attractive two new policies, which have been introduced with effect from 1-7-1985 are: *(i)* "Jeevan Sathi" — Double Joint Life Policy with Profits, and *(ii)* "Jeevan Mitra" — Double Cover Endowment with Profits.

Surrender Value

The 'surrender value' denotes that value or consideration which the insurer is prepared to pay at any particular time during the currency of the policy, after it has run for a specified period, in total discharge of the contract, in case the assured wishes to surrender his policy and extinguish his claim upon it. In brief, the Surrender Value is the cash value of the policy which is payable to the policy-holder if he decides to terminate the contract.

[4]The Children's Deferred Endowment Assurance Policy cannot be with profits during the Deferment period.

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When policy acquires surrender value? A policy acquires a surrender value only after it has run for a specified period. In this regard the Life Insurance Corporation of India now provides as follows:

(a) In the case of policies completed before 1st April 1973, the policy will acquire surrender value: *(i)* after two full years' premiums have been paid, when the term is 20 years or more; *or (ii)* after 1/10th of the total premiums due have been paid, where the term is 11 to 19 years; *or (iii)* after more than one year's premium is paid, where the term is 5 to 10 years.

(B) In the case of policies completed on and after 1st April 1973, the policy will acquire surrender value after payment of *three* full year's premiums.

(c) In the case of policies completed on and after 1st January 1976, the policy will acquire surrender value after payment of *five* full years' premiums *or* for at least one-fourth of the total term of the policy, whichever is less, but payment of at least three full years' premiums is necessary in any case.

(d) In case of policies completed on or after 1st January 1979, the policy will acquire surrender value after payment of at least *three* full years' premiums. Further, this relaxation will be extended retrospectively to all policies and hence the new rule restores the 'status quo ante' prevailing till 31st December 1975. Thus, no policy-holder will be adversely affected by the five year rule in force earlier.

The surrender value increases with each payment of premium, though it is only a fraction of the total amount paid by way of premia. The actual surrender value calculation chart is appended in the policy itself. Generally the minimum surrender value allowable is equal to 30 per cent of the total amount paid by way of premia, excluding the premium of the first year and all extra premiums paid for accident benefit etc. Further, if the policy is one with profits, the cash value of any existing vested bonus additions will also be allowed.

Paid-up Value

If, after the policy has acquired a 'surrender value', a policy-holder discontinues the payment of the premium, the policy does not become wholly void but continues to subsist as a 'paid-up policy'. In such a case, the policy-holder becomes entitled to the 'paid-up value' of the policy. Of course, such a value is payable only at the maturity of the policy; and it is for this reason that this value is always higher than the 'surrender value' which is payable immediately on surrendering the policy.

The 'paid-up value', is the amount which bears the same proportion to the sum assured as the number of premiums actually paid bears to

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number of premiums stipulated for in the policy. In the shape of a formula:

$$\text{Paid-up value of the sum assured} = \frac{\text{No. of years premiums paid}}{\text{No. of years premiums payable}} \times \text{Sum assured.}$$

ILLUSTRATION. Suppose *P* has an endowment policy 'without profits' of Rs 15,000 for 15 years, annual premium payable being Rs 1,200. He discontinues the payment of the premium after five years. The 'paid-up value' of the policy is 5/15 X 15,000 = Rs 5,000.

In the case of 'with profits' policies, the existing vested bonus additions will also be added to the 'paid-up value'.

Loan Value

Where the policy has acquired a 'surrender value,' it also acquires a 'loan value.' The Loan Value is calculated at 90 per cent of the Surrender Value in the case of policies which are in force for full sum assured and 85 per cent of Surrender Vale in case of policies which are in paid-up condition. The amount is then rounded off to the nearest lower multiple of Rs 5. Loans for amounts less than Rs 150 are not given. In the case of policies issued after 1st January 1976, loans for amounts less than Rs 250 are not granted. Loans are granted subject to such further terms and conditions as the Life Insurance Corporation may fix from time to time. The rate of interest charged at present is 9 per cent per annum and it is payable half-yearly. Loans are not granted for a shorter period than six months. This is the best investment that the Corporation can make, as there is never any danger of the money being lost, because in case the loan is not repaid within the agreed time, it along with interest accumulation is deducted from the claim amount when the policy is finally surrendered or falls due.

Assignment of Life Policies

A life insurance policy is more than a proof of contract, it is a property. On the death of the insured, the legal representatives of the insured can collect the sum assured which forms part of the insured's estate in the same way as any other debt due to the insured. The holder of a life policy can deal with it like any other property. He can sell it, assign or transfer it as a security for a loan, or give it away as a gift.

The assignment is the mode of transferring the rights of the transferor in respect of the policy to the assignee. A life policy, being an actionable claim, cannot be transferred by mere delivery like a personal chattel. It needs assignment for transfer. The rules relating to the assignment of life policies have been laid down in Section 38 of the Insurance Act, 1938, which are as follows:

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1. A transfer or assignment of a policy of life insurance, whether with or without consideration, may be made only by an endorsement upon the policy itself or by a separate instrument, signed in either case by the transferor or by the assignor or his duly authorised agent and attested by at least one witness, specifically setting forth the fact of transfer or assignment.

2. The assignment or transfer becomes binding upon the insurer only after a *notice* in writing of such assignment together with certified (by both the transferor and transferee) copy of the endorsement or the deed of assignment is delivered to him by the assignee or the assignor. The insurer recognises the rights of the assignee (as the only person entitled to benefit under the policy) from the day of the receipt of the notice, but his rights shall be no better than those of the assignor, *i.e.,* the assignee shall be required to pay premium *etc.,* in future and if premiums shall not be paid, the policy shall be alive upto its 'paid-up value' only.

3. If the policy has been assigned to more than one assignee under separate deeds of assignment, the priority of the claims of the assignees shall be governed by the order in which the said notices to the insurer are delivered. Thus, where a policy of Rs 20,000 is assigned to *P, Q* and *R* under separate instruments of assignment, as security for the loan given by them to the tune of Rs 10,000, 8,000 and 4,000 respectively and the notices are delivered to the insurer by the three assignees in the same order, the insurer will be liable to pay in full to *P* Rs 10,000 *Q* Rs 8,000 and *R* the balance of Rs 2,000.

4. Upon the receipt of the notice referred to above, the insurer shall record the fact of such transfer or assignment together with the date and the name of the assignee. The insurer is bound to grant a written acknowledgement of the notice on the request of the person by whom the notice was given or of the transferee or assignee on payment of a fee not exceeding Rupee one.

5. The assignment may be absolute or conditional. Thus, an assignment in favour of a person made with the condition that it shall be inoperative or that the interests shall pass to some other person on the happening of a specified event during the life time of the persons whose life is insured, and an assignment in favour of the survivor or survivors of a number of persons, shall be valid.

It is important to note that a valid assignment is irrevocable and cannot be cancelled subsequently.

Nomination by the Policy-Holder

The holder of a life policy *on his own life* has a statutory right to nominate any person to receive the policy money in the event of his death

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before the maturity of the policy. The person to be nominated is called the 'nominee'. The insurer is bound to pay the policy money to the nominee in the event of the death of the insured. It is important to note that a nominee cannot be appointed to receive the sum assured when the policy is surrendered or in the event of the insured dying after the maturity of the policy. It is only in the event of death of the policy-holder before the maturity of the policy that the amount secured is payable to the nominee. During the lifetime of the policy-holder, he continues to have interest in the policy notwithstanding the nomination. It does not divest him of the rights in the policy and he retains disposing power over it.

The 'nomination' simply provides that the policy money is payable to the nominee and the insurer need not look to the legal representatives of the deceased insured. In *D.M. Mudaliar* vs *Indian Insurance and Banking Corporation (1957),* it was held that the nomination does no more than make the nominee a 'receiver' to receive the money from the insurer without deciding the question of title. In the absence of nomination, the payment of claim may be delayed due to involvement of legal proceedings. The claimant will have to present 'succession certificate' from a competent court of law which involves delay and expense. To avoid this delay and expense, nomination is usually preferred by the policy-holder.

It may be noted that only a holder of a policy of life insurance *on his own life* may made a nomination. The assignee or transferee of the policy cannot nominate. Further, in the case of a joint life policy, the insured persons cannot nominate because the amount thereunder is payable to the survivor(s) on the death of the first of the assured lives. In such a case, nomination can be made only to receive money in the event of simultaneous death of all the persons insured.

Section 39 of the Insurance Act, 1938, makes the following provisions regarding 'nomination' by a policy-holder:

1. The holder of a policy of life insurance *on his own life* may, when effecting the policy or at any time before the policy matures for payment, nominate a person to whom the amount secured by the policy shall be paid in the event of his death. (Usually nomination is made at the time of taking the policy.) The policy-holder may also appoint more than one nominee.

2. The nomination, in order to be effectual, must *either* be incorporated in the text of the policy itself *or* be made by an endorsement on the policy. In the latter case the fact of nomination must be communicated to the insurer who shall register it and issue an acknowledgement of the same.

3. Any such nomination may, at any time before the policy matures for payment, be cancelled or changed by a further endorsement on the policy or by a 'will' by the assured, and notice given to the insurer thereof. Note

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that the insurer will be bound only after notice is given to him of any such cancellation or change. The insurer must register the same and issue a written acknowledgement thereof.

4. An 'assignment' of a policy (made in accordance with Section 38) shall automatically cancel a nomination, except an assignment to the insurer to secure a loan which shall affect the rights of the nominee only to the extent of the insurer's interest in the policy.

5. Where the policy matures for payment during the lifetime of the person whose life is insured, or where the nominee or, if there are more nominees than one, all the nominees die before the policy matures for payment, the policy money shall be payable to the policy-holder or his heirs as the case may be.

6. Where the nominee survives the policy-holder, the amount secured by the policy shall be payable to the nominee.

Distinction between Assignment and Nomination

1. On assignment of life policy, all the rights of the policy-holder pass to the assignee. The title to the policy passes to the assignee by reason of the assignment. Nomination does not divest the policy-holder of his rights in the policy and he retains disposing power over it. Nomination simply gives the nominee a right to receive the policy money from the insurer in the event of death of the policy-holder before the maturity of the policy.

2. For a valid assignment some consideration is essential unless it is made by way of a gift. But nomination does not require any consideration.

3. Unlike assignment, nomination may be changed or cancelled at any time before the policy matures for payment. Moreover, an assignment automatically cancels a nomination except in case of a loan where it shall effect the rights of a nominee only to the extent of insurer's interest in the policy.

4. In case of assignment, money under the policy shall be paid to the assignee even if the policy-holder is alive on the date of maturity. But in the case of nomination, the nominee shall be paid the policy money only if he survives the assured. The nominee has no right to collect the policy amount during the life-time of the assured.

Days of Grace

Days of grace is that period during which the policy does not lapse on the ground on non-payment of premium on the due date. The insurance cover continues uninterrupted during these days even without payment of premium for the current period. In the case of policies issued by the Life Insurance Corporation of India, one month but not less than 30 days of grace are allowed for payment of yearly, half-yearly or quarterly premiums, and 15 days for monthly premiums. If death occurs within that period and

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before payment of the premium then due, the policy will still be valid and the sum assured will be paid after deduction of the said premium, as also the unpaid premiums falling due before the next anniversary of the policy. Days of grace are counted from the next day on which the premium falls due.

Revival of Discontinued or Lapsed Policies

When the premium is not paid within the days of grace, the policy lapses, but may be revived during the life-time of the Life Assured, but within a period of five years from the due date of the first unpaid premium and before the date of maturity on the following terms:

(a) Within six months from the due date of the first unpaid premium without evidence of health on payment of the premiums in arrears with interest at the rate of $7^1/_2$ per cent per annum for each month or portion of a month, reckoning from the due date of each premium paid late, subject to a minimum payment on this account of rupee one.

If revival is completed within 14 days *or* in case of policies issued after 28 September 1972, within one month from the expiry of the days of grace, a simple revival charge of rupee one only will be required, no matter what the amount of the premium may be.

(b) At any time after the first six months from the due date of the first unpaid premium but not later than the expiry of a period of five years from the due date of the first unpaid premium on production of evidence of health and habits of the Life Assured (including a Medical Report on his life from Corporation's appointed Medical Examiner, whenever required by the Corporation, the fee for which must be paid in advance) to the satisfaction of the 'Corporation and of evidence to show that there has been no adverse change in personal or family history or occupation and on payment of the premiums in arrears with interest thereon at the rate of $7^1/_2$ per cent per annum compounding half yearly reckoning from the due date of each premium paid late.

Claims Concession Clause. It is important to note that according to the Claims Concession Clause, contained under the terms of the policies of assurance, if, after at least *three* full years'premiums have been paid, the death of the assured takes place within *six months* from the due date of the first unpaid premium, the policy moneys will be paid as if the policy had remained in full force after deduction of *(i)* the premium or premiums unpaid with the interest thereon to the date of death, and *(ii)* the unpaid premiums falling due before the next anniversary of the policy. In the recent past the scope of the claims concession allowed under the policies of assurance has been enlarged by adding a separate Special Claims Concession Clause. Accordingly, if, after at least *five* full years' premiums have

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been paid, the death of the assured takes place within a period of *twelve months* from the due date of the first unpaid premium, full claim will be paid, subject to deduction of the unpaid premiums with interest along with the premium falling due before the next anniversary of the policy.

Loss of Policy

If the insurance policy document is lost or gets destroyed for some reason, the Life Insurance Corporation will issue another policy document after the assured has executed a bond of indemnity and has paid the required fees to the Corporation. Intimation of such a loss must be given to the concerned Divisional Office of the LIC immediately and a public advertisement to this effect must also be given in newspapers. Public advertisement may, however, be waived if the sum assured is upto Rs 10,000.

Proof of Age

The age of assured is a material fact for the insurer because it has a direct bearing on the risk undertaken by him. Moreover, the amount of premium to be charged is also calculated on the basis of age of the Life Assured as declared in the Proposal. The insurer may, therefore, require proof of age to be furnished at the time of the proposal itself or at any time after issue of the policy. In the following types of cases, the proof of age must invariably accompany the proposal form, as the proposal will not be completed unless the age is proved:

(i) where the life to be assured has not completed 20 years of age;

(ii) where the life to be assured has completed 50 years of age;

(iii) where the proposal is under the Children's Deferred Endowment Assurance Plan, proof in support of *(a)* the age of the life to be assured and *(b)* the age of the proposer, if the 'premium waiver benefit' is desired:

(iv) where a Supplementary Benefit is desired under a Multi-purpose Policy, proof in support of the age of the Beneficiary child;

(v) where the proposal is under the Immediate Annuity, Deferred Annuity Plans or Retirement Annuity;

(vi) where the proposal is under Temporary Assurance Plan or the Convertible Term Assurance Plan;

(vii) where the proposal is under Salary Savings Scheme.

Acceptable proofs of age. These proofs will generally be accepted: (1) Certified Extract from Municipal or other Records made at the time of birth; (2) Certificate of Baptism or Certified Extract from Family Bible if it contains age or date of birth; (3) Certified Extract from School or College Records if age or date of birth is stated therein; (4) Certified Extract from Service Register in the case of Government employees and employees of quasi Government Institutions; (5) Original horoscope.

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If no proof is available, then an affidavit on oath is acceptable. When the insurer is satisfied with the proof of age furnished, an endorsement is made on the policy that age is admitted, or a certificate that his age is admitted is issued to the Life Assured. Once the age is admitted, it cannot afterwards be disputed except in the case of fraud.

Effect of Suicide

All policies issued by the Life Insurance Corporation of India contain a clause regarding the liability of the Corporation in case of suicide. Accordingly, if the assured commits suicide within one year of the commencement of the risk of the Corporation on the Policy, the LIC will not be liable for the policy money. In other words, suicide by the assured does not effect the liability of the Corporation and LIC pays the claim if the policy has run for one year. However, if the insurance policy has been assigned to some person for valuable consideration and the LIC has been intimated of this fact at least one month before the date of the suicide, the Corporation will be liable to the assignee to the extent of his beneficial interest in the Policy, even if the assured has committed suicide within a year of the issue of the Policy.

Settlement of Claims

When the policy matures for payment due to the death of the assured or the expiry of the period specified in the policy, the amount of the policy can be claimed from the Life Insurance Corporation. When making the claim, the following steps have to be taken:

1. **Proof of title.** A person claiming on the maturity of the policy has to furnish the proof of his title to the policy amount to the Divisional Office of the LIC where the policy is serviced. The assured himself can claim the policy money, if the policy matures during his life-time. In the event of the death of the assured, the assignee or the nominee or the legal representative, as the case may be, will have to establish his legal title to the amount of the policy. The legal representative is required to furnish a 'succession certificate' in proof of his title. Where there are conflicting claims or insufficiency of proof of title, the LIC pays the amount of claim through the Court.

2. **Proof of death.** Where the policy money is claimed on the death of the insured, the death must be proved. The proof of death may be given by a death certificate from the Municipal authorities on the basis of entries in the death register *or* by oral testimony of the persons who were present at the last rites of the deceased *or* by presumptive evidence under Section 108 of the Indian Evidence Act, *i.e.,* the person has not been heard of for seven years by those who would naturally have heard of him if he had been alive.

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It may be mentioned that the cause of death is immaterial, *i.e.*, whether it is caused by suicide (provided the policy has run for one year) *or* murder *or* military operation, it is covered under the policy, unless specified otherwise in the terms of policy. Of course, death on account of capital sentence (*i.e.*, sentence to death because of the criminal act of the assured) is not covered under the policy, unless otherwise specified.

3. **Proof of age.** If the proof of age has not been furnished already, it will have to be submitted at the time of making a claim. In case the age of the Life Assured is found higher than what was declared in the proposal, the LIC cannot refuse to pay the claim. Of course, it can deduct, out of the amount of the policy, the amount of accumulated difference between the premium for the correct age and the original premium from the commencement of the Policy upto the date of such payment, with interest on each instalment of such difference at $7^1/_2$ per cent per annum.

TEST QUESTIONS

1. Define a contract of life insurance. How does life insurance differ from other forms of insurance?
2. Discuss the law relating to 'insurable interest' in the case of life insurance. State the cases where *insurable interest* is presumed to exist and where it is not presumed to exist.
3. Discuss the procedure for effecting a life insurance policy.
4. What are the different types of life insurance policies?
5. What is meant by the Surrender Value of a life policy? Distinguish between Surrender Value and Paid-up Value of a life policy.
6. Distinguish between an Assignment and a Nomination in life insurance, bringing out clearly the rights of the assignee and nominee.
7. Write notes on: *(a)* Days of grace, *(b)* Revival of lapsed policies, *(c)* Proof of age.

PRACTICAL PROBLEMS

Attempt the following problems, giving reason for your answers:

1. *X* owes *Y* Rs 10,000. *Y* insures *X*'s life for a like amount. *X* pays the debt to *Y*. *X* then dies. *Y* claims Rs 10,000 from the insurance company. Is the insurer liable to pay?

[**Hint.** Yes, the insurer is liable to pay Rs 10,000 to *Y*, because in a life insurance contract insurable interest is necessary only at the time of taking the policy.]

2. *P* takes a policy on his own life on 15th January 1992, and later commits suicide on 24th September 1993. Is the LIC liable?

[**Hint.** Yes, the LIC is liable, as the policy has already run, on the date of suicide, for more than one year.]

3. On 1 February 1992, *A* assigned his life policy to *B* for valuable considera-

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tion by executing a deed of assignment. On 1 March 1993, *A* assigned the same policy to *C* as a gift by separate deed of assignment, and gave notice of the assignment in favour of *C* to the Life Insurance Corporation in the prescribed manner. Both *B* and *C* claim the amount of the policy on maturity. How would you decide?

[Hint. Only *C* is entitled to claim the amount of the policy because as per Section 38 of the Insurance Act an assignment becomes binding on the insurer only after a notice thereof is delivered to him. As no notice of assignment in favour of *B* was given, the LIC will not recognise the claim of *B*.]

4. *A*, the holder of a policy of life insurance on his own life assigned it to his wife, *B*, on the condition that the benefits under the policy are to revert to him should *B* die during his life-time. A year later *A* revoked the assignment on the ground that it was conditional. Thereafter *A* died during the life-time of *B*. Both *B* and *A*'s legal representatives claimed the policy money. Whose claim will prevail and why?

[Hint. *B*'s claim will prevail. Section 38 of the Insurance Act permits "conditional assignment". Hence the assignment made in favour of *B* was valid. The assignor cannot revoke an assignment once validly made. As such the policy remained assigned to *B* and on *A*'s death she is entitled to get the policy money (*Bai Lakshmi* vs *Jaswantlal Tribhuvandas,* 1947, A.I.R. Bom. 369)].

5. *P*, the holder of a policy of life insurance on his own life nominates *Q* as has nominee. Before the maturity of the policy *Q* dies. On the maturity of the policy *Q*'s heirs claim the policy money. Will they succeed?

[Hint. No, *Q*'s heirs will not succeed because as per Section 39 of the Insurance Act where the nominee dies before the policy matures for payment, the policy money shall be payable to the policy-holder or his heirs.]

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Chapter 33

Fire Insurance

The contracts of fire insurance are governed by the Insurance Act, 1938 (as amended up-to-date) and the General Insurance Business (Nationalisation) Act, 1972, besides the judicial decisions of courts in England and India. The fire insurance business has been nationalised through the General Insurance Business (Nationalisation) Act, 1972.[1] From 1st January 1974, fire insurance business is being transacted only by the General Insurance Corporation of India (GICI), formed in accordance with the aforementioned Act, and its four subsidiaries.[2]

Definition of a Contract of Fire Insurance

Fire insurance means insurance against any loss of or damage to property by fire. A contract of fire insurance is a contract whereby the insurer, in consideration of the premium paid, undertakes to indemnify the insured against financial loss which the latter may sustain by reason of certain defined subject-matter being damaged or destroyed by fire during a specified period, subject to the condition that the actual amount of indemnity will never exceed the amount of the policy.

Characteristics. The characteristics of a contract of fire insurance are as follows:

1. It is a contract of *indemnity*. The insured suffering the loss in a fire policy can only recover to the extent of the actual loss, so far as it does not exceed the sum insured.

2. It is a contract of *utmost good faith, i.e., 'uberrimae fidei'*. The

[1]As the first step towards nationalisation of fire, marine and miscellaneous insurance (*i.e.*, general insurance) business in India, the President issued an Ordinance, on 13 May 1971, empowering the Government to take over the management of all companies, both Indian and foreign, engaged in general insurance business. The Ordinance was subsequently replaced by the General Insurance (Emergency Provisions) Act, 1971. Later on the General Insurance Business (Nationalisation) Act, 1972 was passed.

[2]Refer to Chapter 31, Sub-heading "*Nationalisation of Insurance Business,*" for further details.

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proposer is under an obligation to supply detailed information regarding the subject-matter to be insured. He must disclose all material facts correctly and fully, otherwise the contract is voidable at the instance of the insurer.

3. It is a contract from *year to year* and therefore a fire insurance policy can be issued for a period of one year only.

4. The principles of 'subrogation' and 'contribution' apply to a contract of fire insurance (*see* these principles in Chapter 31).

5. It covers loss caused proximately by fire (*see* next side-heading for details).

6. Unlike a life insurance policy, a fire policy does not carry any Surrender Value or Paid-up Value.

7. The assured must have *insurable interest*[3] in the subject-matter, *i.e.*, the property insured, both at the time of contract as well as at the time of loss. Unlike a life insurance contract, in a fire insurance contract insurable interest must also exist *at the time of the loss* because it is a contract of indemnity and unless the assured or the assignee has interest in the property insured at the time of loss, he cannot be indemnified. The following have been held to have an insurable interest:

(*a*) The owner of goods or property, upto its full value.

(*b*) The mortgagee, pledgee, bailee, factor, carrier, trustee, etc. All these persons have insurable interest because they all run a risk, have something to lose by the happening of the peril insured against. But they have only 'limited interest' in the goods or property and as such have insurable interest to the extent of their pecuniary interest in the subject-matter. If the insured has only 'limited interest' in the property or goods, he can validly insure them only upto the amount of insurable interest he has therein at the time of entering into contract. Further, the insured shall not be indemnified more than the insurable interest he has in the subject-matter at the time of loss.

It is worth noting that husband and wife have insurable interest in each other's property to the extent of its full value because both of them have a right of common enjoyment. A creditor has no insurable interest in the property of his debtor because the debtor is personally liable and his property is liable on default, through Court only.

What is 'Fire' and 'Loss or Damage by Fire'?

'Fire' within the meaning of a Fire Policy means fire which has broken bounds and is fortuitous in its nature. There must be actual ignition or burning, whether accidental or otherwise. Heating unaccompanied by ignition is not fire. So, unless there be actual ignition and the loss be

[3] See the meaning of *Insurable Interest* in Chapter 31.

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proximately caused by such ignition, the insurers are not liable. Thus, where sugar was spoilt by great heat caused due to a ventilator in the chimney being closed, but there was not actual ignition, it was held that the assured could not recover (*Austin* vs *Drewe*[4]). Similarly, the heat of the sun often contracts timber, but that would not be considered as loss by fire. Note that had the heat might be caused by actual ignition of premises where the sugar or timber was kept, the damage shall be deemed as 'damage by fire,' although the subject-matter, namely the sugar or timber, has not been actually burnt. It is so under *causa-proxima,* to which we now turn.

Causa proxima in fire insurance. The principle of *causa proxima* applies in fire insurance. If the proximate cause of loss or damage is fire, the loss is recoverable. The subject-matter of insurance need not have been burnt. Ignition (*i.e.*, burning) must be of the goods insured or the premises where it is lying. The expression 'loss or damage occasioned by fire' means "loss or damage either by ignition of the article consumed, or by ignition of part of the premises where the article is: in the one case there is loss, in the other a damage, occasioned by fire."[5] Thus, where the 'stock of medicines' was insured against fire and there was ignition on the premises of the shop as a result of which most of the medicines were damaged because of excessive heat, it was taken to be a loss or damage caused by fire. Remember that if the medicines are spoiled by high heat of the sun, the damage shall not be deemed as 'damage by fire' as there is no ignition. Hence, in order to cover a particular loss or damage under a Fire Policy, the following three things must be present:

(*a*) the loss or damage must relate to the subject-matter of policy;

(*b*) the loss or damage must be caused by ignition or fire; and

(*c*) the ignition must be either of goods insured or of the premises where it is placed.

It is to be noted that the cause of fire is immaterial for a fire insurance claim to be admitted. If the loss happens by fire, it is recoverable from the insurer, unless it is deliberately brought about by the assured himself or his agents, it matters not how the flame is kindled—whether it be the result of accident or design. Even if it is caused by the negligence of the assured or his servants, the insurer shall continue to be liable (*Dudgeon* vs *Pembrake*[6]).

On the basis of judicial decisions the expression 'loss or damage by fire' also includes the loss or damage caused by efforts to extinguish fire with a view to mitigating the loss. Thus, the following losses *are covered* by fire insurance:

[4](1816), 4 Camp. 360.

[5]Per Byles J. in *Everett* vs *London Assurance,* 34. L.J.C.P. 301.

[6](1877), 2 App. Cas. 284.

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(*a*) property damaged or goods spoiled by water used to extinguish the fire;

(*b*) fire brigade destroying an adjacent house to prevent the progress of flames;

(*c*) wages paid to persons engaged for extinguishing fire;

(*d*) loss arising from efforts to avert damage by fire, *e.g.*, removal of goods from the building where fire is raging. Even the damage caused by throwing furniture out of window is included.

The following types of losses, however, *are not covered*[7] by a fire policy:

(*i*) Loss by theft during or after the occurrence of a fire.

(*ii*) Loss or damage to property occasioned by its own fermentation or spontaneous, combustion, *e.g.*, if a Bomb is insured, which explodes itself because of inherent defect, the loss is not covered.

(*iii*) Loss caused by the burning of property by order of any public authority.

(*iv*) Loss caused by subterranean (underground) fire.

(*v*) Loss happening by fire which is caused by earthquake, war, invasion, act of foreign enemy, hostilities or warlike operations (whether war be declared or not), civil war, mutiny, riot, military or usurped power, martial law, and military rising.

In the above cases the insurer is not liable, unless specially provided for in the Policy.

Successive losses. In case of a fire policy for a fixed period, as is usual, the insurer is liable for successive losses, even if the total payment exceeds the policy amount. If partial loss is immediately followed by total loss, then only total loss can be recovered.

Procedure for Effecting Fire Insurance

For taking out a fire policy the proponent has to fill a proposal form giving necessary description such as location, amount, age, nature of possession, *etc.*, of the property. While filling up the proposal form, the proposer must observe utmost good faith and disclose all the material facts. On receiving the proposal form the insurer assesses the risk to be insured. The property is fully inquired and examined by the surveyors who determine the degree of risk precisely. If the insurer thinks that the property is insurable, he gives his acceptance of the proposal subject to the payment of premium. The risk will commence only when the premium is paid. After the receipt of the premium the insurer will issue a 'cover note' which is in

[7]Based on the conditions stated at the back of the Policies issued after the nationalisation of the General Insurance business.

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the nature of an interim protection note and covers the property until the final policy has been issued. If loss occurs before the issue of policy, the 'cover note' will be sufficient to make the insurer liable for payment of the loss. Finally, a fire insurance policy duly stamped and containing the terms and conditions of insurance will be issued by the insurer to the assured.

Types of Fire Policies

The different types of fire policies are as follows:

1. **Ordinary fire policy.** It is a policy in which the policy-amount is equal to the real value of property or goods, and the insurer indemnifies the assured in cash, usually for the depreciated value at the date of loss, subject to the amount stated in the policy.

2. **Specific policy**. It is a policy in which the policy amount is less than the actual value of the property. In other words, it is a case of 'under insurance' policy, not subject to 'average clause.' Under such a policy, in case of loss the insurer is liable to indemnify the actual loss in full not exceeding the specified sum in the policy, irrespective of under insurance. Thus, if a property worth Rs 50,000 is insured against fire for Rs 40,000, and the damage of the property is assessed at Rs 20,000, the insured will get the whole loss, *viz.*, Rs 20,000 made up by the insurer.

3. **Average policy**. A fire policy containing an 'average clause' is called an average policy. The 'average clause' lays down that if, at the time of loss by fire, the actual value of the property insured is greater than the sum assured under the policy, then the insured shall be considered as being his own insurer for the difference, and shall bear rateable proportion of the loss accordingly. In other words, under the 'average clause' the insurer and insured share the loss in proportion to the risk that each is carrying. The insurer will bear only that proportion of the actual amount of loss which the insured amount bears to the real value of the property. To the extent of under-insurance, the assured is deemed to be a self insurer. Thus, if a property worth Rs 50,000 is insured only for Rs 40,000, and, if the actual loss is assessed at Rs 20,000, the claim will be settled at

$\frac{40,000}{50,000} \times 20,000 = 16,000$ and the balance of Rs 4,000 will be borne by the insured himself, for he is deemed to be a self insurer for Rs 10,000 (the difference between the real value of the property and the insured amount). In other words, the loss shall be borne in the ratio of 4:1 in between the insurer and the assured. It is important to note that this clause comes into operation in case of partial loss only, and if there is a total loss, the insurer is liable to pay the full sum assured. Thus, in the above illustration if there is total loss which is assessed at Rs 50,000, the claim will be settled at

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$\frac{40,000}{50,000}$ x 50,000 = Rs 40,000 which is equal to the insured amount.

The main object of inserting the 'average clause' in a fire policy is to check under-insurance and to encourage full insurance. Such a clause is usual in fire policies now-a-days.

4. **Valued policy.** It is a policy under which the insurer undertakes to pay the insured the fixed policy amount, in the event of the total loss, without demanding any further proof of the value of the property lost, at the time of fire. (Under an ordinary fire policy, in the event of total loss, the insurer indemnifies the assured for actual loss proved, subject to the amount specified in the policy). Note, that if there is a partial loss, then only the actual loss shall be indemnified, because nobody is allowed to make a profit out of his loss. Such policies are not very common.

5. **Re-instatement or Replacement policy.** In this type of policy the insurer undertakes to pay the cost of replacement of the property destroyed by new property, and not the depreciated value of the property lost, of course subject to the amount of the policy. Alternatively, the insurer may himself re-instate the property instead of paying in cash.

6. **Floating policy.** When one policy covers properties situated at different places or different properties situated at a particular place under one sum and for one premium, it is called a floating policy.

7. **Consequential loss policy.** Under this type of policy, the insured is indemnified: (*a*) for the loss caused by fire, and (*b*) for the loss of profits which he sustains due to interruption of his business as a result of fire. This type of policy is also known as 'Loss of Profits Policy'.

Assignment of Fire Insurance Policies

Before the occurrence of any loss, a fire policy cannot validly be assigned unless the property insured is also transferred to the assignee, and sanction of the insurer is obtained.[8] The transfer of the property insured to the assignee is essential because for a valid claim against the insurer, the assignee must have an insurable interest in the property insured at the time of loss. The consent of the insurer is necessary for a valid assignment because a contract of fire insurance is regarded as a contract of personal nature. The assignment must be in writing either by endorsement on the policy or by a separate deed of assignment. It is worth noting that no consent of the insurer is required if the interest in the property insured

[8]Based on the conditions stated at the back of fire policies issued after the nationalisation of General Insurance business.

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passes from the insured by 'will' or by operation of law to his heirs on his death.[9]

After the occurrence of the loss, the policy can be assigned in writing to any person, just like an actionable claim, because in such a case, assignment means that the assignor has transferred his own right of claim to the assignee.

Fire Insurance Claim

On the happening of any loss or damage to the property or goods insured, the assured should follow the following procedure to register and recover his claim under a fire insurance policy:

1. *Notice of loss.* The insured must forthwith give notice in writing of the loss to the insurance company.

2. *Report to the police in case of arson.* If the loss has been caused by arson (i.e., miscreants' deliberate act of burning the property), the matter should at once be reported by the insured to the police, and a copy of the report should be sent to the insurance company.

3. *Submitting statement of claim.* Within 15 days after the loss or damage, the insured is further required to submit to the insurance company: (*a*) a claim in writing for the loss or damage containing in particular an account, as may be reasonably practicable, of all the several articles or items of property damaged or destroyed, and of the amount of the loss or damage thereto respectively, having regard to their value at the time of the loss or damage, not including profit of any kind, and (*b*) particulars of all other insurances, if any.

4. *Evidence to support claim.* The insured must also at all times at his own expense produce, procure and give to the insurance company all such further particulars, books, vouchers, invoices, documents, duplicates or copies thereof, and information with respect to the claim and the origin and cause of the fire and the circumstances under which the loss or damage occurred and any matter touching the liability of the insurer, *as may be required by the insurer* together with a declaration on oath of the truth of the claim and of any matters connected therewith.

In case the insured does not comply with the above requirements, or hinders or obstructs the insurance company's valuers in arriving at a fair valuation, no claim under the policy shall be payable. The insured will also lose all benefits under the policy in case he makes a fraudulent claim (*i.e.*, intentional over-valued claim). Of course, if over-valuation is by mistake, the claim shall be paid, because valuation is generally a matter of opinion.

[9] *Ibid.*

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TEST QUESTIONS

1. Define a fire insurance contract. What are the characteristics of a fire insurance contract?

2. What is the meaning of 'fire' in a fire insurance policy? What types of losses or damages are covered by a fire policy? Also, specify the types of losses not covered under a fire policy.

3. What is Fire Insurance? Explain the different kinds of fire policies.

4. What are the different kinds of fire policies?

5. (*a*) How a fire policy may be assigned?
   (*b*) How a claim under a fire policy should be made?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. A house covered by a fire policy catches fire. In the confusion that followed, a theft is committed. Discuss the liability of the insurer.

[**Hint**. Loss by theft during or after the occurrence of a fire is not covered by a fire policy. As such the insurer is not liable for such loss.]

2. *P* insured his house against loss by fire. Later, while insane, he killed his wife, severely injured his only son, set fire to the house, and died in the fire. The son survived and sued the insurers for the fire loss. Is he entitled to recover?

[**Hint**. Yes, the son is entitled to recover on the policy, for the insured caused the fire when he was insane, and not deliberately.]

3. *A*, insured his house worth Rs 60,000 for Rs 40,000 against risk by fire. There is an "average clause" in the policy. In the fire the house was burnt to ashes. *A*, claimed the whole insured amount. The insurers pleaded the "average clause." Decide.

[**Hint.** *A*, is entitled to recover the whole insured amount of Rs 40,000, because the "average clause" does not come into operation in the case of total loss. This clause comes into play only if there is a partial loss.

4. *P* got his goods lying in a godown insured against fire. The goods were destroyed by fire. *P* recovered full compensation for goods from the insurance company. *P* then sued the godown-keeper and recovered a sum of Rs 5,000 from him. The insurance company claims this amount of Rs 5,000 from *P*. *P* refuses to pay. Decide.

[**Hint.** *P* is bound to pay the amount of Rs 5,000, which he recovered from the godown-keeper, to the insurance company, because a contract of fire insurance is a contract of indemnity and in case of a loss the assured cannot make a profit of his loss, Moreover, after fully indemnifying the assured, the insurer subrogates to all the rights of the assured against the third parties.]

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Chapter 34

Marine Insurance

The contracts of marine insurance are governed by the Insurance Act, 1938, the Marine Insurance Act, 1963, and the General Insurance Business (Nationalisation) Act, 1972. The main Act regulating the marine insurance business is the Marine Insurance Act, 1963, and references in this chapter are to that Act, unless otherwise stated.

The marine insurance business has been nationalised through the General insurance Business (Nationalisation) Act, 1972. From 1st January, 1974, marine insurance business is being transacted only by the General Insurance Corporation of India (GICI), formed in accordance with the aforementioned Act, and its four subsidiaries.[1]

Definition of a Contract of Marine Insurance

A contract of marine insurance is a contract whereby the insurer (also called the underwriter) undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against *Marine losses,* that is to say, the losses incidental to marine adventure (Sec. 3). The contract may also, by its express terms, or by usage of trade, be extended so as to protect the assured against losses on *inland waters* or on any *land risk* which may be incidental to any sea voyage [Sec. 4(1)].

Subject-matter of a Contract of Marine Insurance

Every lawful marine adventure may be the subject-matter of a contract of marine insurance (Sec. 5). Thus, marine insurance may be effected in relation to all such interests which are exposed to *maritime perils.* The more popular types of marine insurance are as follows:

1. **Hull insurance.** Insurance of vessel and its equipments (*i.e.*, furniture and fittings, machinery, tools, coal and engine stores etc.) are included in hull insurance. The owner of a ship may effect hull insurance.

2. **Cargo insurance.** The insurance of cargo includes goods and merchandise and not the personal belongings of the crew and passengers.

[1]For details of these subsidiaries, refer to Chapter 31, side-heading: "*Nationalisation of Insurance Business.*"

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3. **Freight insurance.** In many instances, under the terms of contract, the shipping company is unable to earn freight, whether paid in advance or otherwise, if the cargoes are not safely transported. As such, if the cargoes are destroyed or the ship is lost on the way, the shipping company loses the freight. To guard against such an eventuality the shipping company may effect freight insurance.

4. **Liability insurance.** Liability insurance includes liability to a third party by reason of hazards like collision, etc.

It is necessary to specify with certainty the subject-matter insured in a contract of marine insurance. The marine policy may cover the ship *or* the cargoes or the same policy may cover the ship, cargoes, freight and liability.

Maritime Perils

As observed earlier, marine insurance policies protect the assured against maritime perils. According to Section 2(*e*), "*maritime perils* mean the perils consequent on, or incidental to, the navigation of the sea, that is to say, perils of the seas,[2] fire, war perils[3], pirates and rovers,[4] thieves, captures, seizures, restraints and detainments of princes and peoples, jettisons,[5] barratry,[6] and any other perils which are either of the like kind or may be specified by the policy."

It is to be noted that the term 'perils of the seas' refers only fortuitous accidents or casualties of the seas. It does not include the ordinary wear and tear, *e.g.*, bursting of boiler or breakage of shaft because of inevitable action of the winds and waves. By the implied warranty of '*seaworthiness*', it is understood that a ship will be in such a condition as to withstand the ordinary waves and winds, and therefore if the ship is sunk because of unseaworthiness (*e.g.*, defective boiler and machinery) at the commencement of voyage, the peril is not a sea peril and the insurer is not liable for any such loss. On the other hand, the ship owner shall be liable to compensate the insurer, for any moneys payable to cargo owners, whose cargoes

[2] *Perils of the seas* cover losses caused by sea water, stranding, cyclone, storm, lightning, fog, rough weather, collision with other ship, striking upon a sunken rock or icebergs.

[3] *War perils* cover loss sustained owing to hostile acts of an enemy.

[4] *Pirates and rovers* means sea robbers and rioters who attack the ship from the shore.

[5] *Jettison* refers to throwing a part of the goods overboard with a view to lighten the ship in order to save the ship and residue of the cargoes in an emergency.

[6] *Barratry* means wrongful act wilfully committed by the captain or crew in contravention of their duties, thereby causing prejudice to the owners, for example, intentionally setting fire to ship or running aground the ship.

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might have been damaged. '*Perils of the seas* usually relate to casualties which might occur, and not to those which must occur'.

The Marine Policy

The instrument embodying the terms and conditions on which the contract of marine insurance is entered into between the insurer and the assured is called a *marine policy.* It is a must for a valid contract of marine insurance. It may be executed and issued either at the time when the contract is concluded, or afterwards (Sec. 24). A contract of marine insurance is deemed to be concluded when the proposal of the assured is accepted by the insurer, whether the policy be then issued or not; and for the purpose of showing when the proposal was accepted, reference may be made to the 'slip', 'covering note' or other customary memorandum of the contract, although it be unstamped (Sec. 23). A marine policy must specify — *(i)* the name of the assured, or of some person who effects the insurance on his behalf; *(ii)* the subject-matter insured and the risk insured against; *(iii)* the voyage, or period to time, or both, as the case may be, covered by the insurance; *(iv)* the sum or sums insured; and *(v)* the name or names of the insurer or insurers (Sec. 25).

A marine policy must be signed by or on behalf of the insurer. Where it is subscribed by or on behalf of two or more insurers, each subscription, unless the contrary be expressed, constitutes a distinct contract with the assured (Sec. 26). The subject-matter insured must be specified in the policy with reasonable certainty. However, the nature and extent of the interest of the assured in the subject-matter insured need not be specified in the policy (Sec. 28). The policy must also be duly stamped under the Stamp Act.

Characteristics of Marine Insurance Contracts

The characteristics of a contract of marine insurance are as follows:

1. It is contract of *indemnity* (except in the case of a "valued policy"[7]) under which the assured can recover only the amount of actual loss, if any, suffered by him subject to the limit of the insured amount.

2. It is a contract based upon the utmost good faith (*i.e.,* a contract *uberrimae fidei*), and if the utmost good faith be not observed by either party, the contract may be avoided by the other party (Sec.19). The assured must disclose to the insurer, before the contract is concluded, every material circumstances which is known to the assured, and the assured is deemed to know every circumstances which, in the ordinary course of business, ought

[7]For details of a "Valued Policy," *see* further under the heading: *"Kinds of Marine Policies'.*

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to be known to him. If the assured fails to make such disclosure, the insurer may avoid the contract (Sec. 20).

3. The doctrine of *'subrogation'* and *'contribution'* apply to a contract of marine insurance. (See these doctrines in Chapter 31).

4. A marine policy is invariably subject to the *'average clause'*. (See 'Average Policy' under Fire Insurance, Chapter 33).

5. All marine insurance contracts are subject to certain *"express and implied warranties."* (See further in this chapter for details).

6. In a marine insurance contract, the assured must have *insurable interest* in the subject-matter insured at the time of the loss, though he may not have insurable interest when the insurance is effected (Sec. 8). (For more details, see further in this chapter).

Kinds of Marine Policies

The different kinds of marine policies are as follows:

1. **Voyage policy** (Sec. 27). Under this policy the subject-matter is insured for a specified voyage and the time that the voyage will take is not taken into account at all. Such a policy may cover the risk "at and from a port," or "from a port," to another port.

2. **Time policy** (Sec. 27). This is a policy whereby the subject-matter is insured for a specified period of time, *e.g.,* from evening 1st October 1992, to evening 30 September 1993. A time policy which is made for any time exceeding twelve months is invalid. This policy has nothing to do with the voyage of the ship. The ship may make any number of voyages during the specified period of time.

3. **Mixed policy** (Sec. 27). This policy is a combination of 'voyage' and 'time' policies, and is also known as "voyage and time policy". It seeks to insure the subject-matter (say, the ship) during a particular voyage for a specified period of time. For example, a ship may be insured for a voyage between Calcutta and Tokyo for a period of seven months under a mixed policy.

4. **Valued policy** (Sec. 29). A valued policy is a policy which specified the agreed value of the subject-matter insured. In the absence of fraud, the value fixed by the policy is regarded as conclusive of the insurable value of the subject-matter intended to be insured, and it will be this value, which the insurer is liable to pay to the assured, in case of total loss, without demanding any further proof of value at the time of loss (unlike an unvalued policy where only the actual loss proved is indemnified subject to the amount of the policy). Note, that if there is a *partial loss,* then only the actual loss shall be indemnified (note exceeding the agreed value), because marine insurance is basically a contract of indemnity.

5. **Unvalued or open policy** (Sec. 30). An unvalued policy is a policy

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which does not specify the value of the subject-matter insured, but subject to the limit of the sum insured, leaves the insurable value to be subsequently ascertained in case of a loss. Unlike a valued policy, in this type of policy the insurer is liable to indemnify the assured only upto the actual loss proved, subject to the policy amount, even in the case of total loss.

6. **Floating policy** (Sec. 31). It is a policy which only mentions the amount for which the insurance is taken out, and leaves the name of the ship or/and description of the cargo to be defined by subsequent declaration(s) by the assured when the risk is actually run. Usually, cargo owners who make regular shipments of cargoes take out a floating policy for a round amount to insure the shipments expected to be made during a certain period of time. Whenever some cargo is shipped, the assured makes a declaration about the description of cargo, name of the ship, and the value of the shipment, by an endorsement on the policy, and the total value of the policy is reduced by that amount. The policy is treated as an 'unvalued policy' as regards the subject of that declaration. Such declarations are made as and when some cargo is shipped till the total policy amount is exhausted and the policy is 'fully declared' or 'run off'.

7. **PPI (Policy Proof of Interest) or Honour Policy** (Sec. 6). It is a policy which is issued when the assured has no insurable interest in the subject-matter insured and has no expectation of acquiring such an interest later on. In other words, in this type of policy the insurer agrees to be liable in the event of loss, without demanding any proof of insurable interest from the assured other than the policy itself. This type of policy contains words like "interest or no interest," or "without further proof of interest than the policy itself". Such a policy is a void policy, being a wagering agreement, in the eye of law and hence also known as "wagering policy". In practice, however, the insurers who issue such policies abide by their liability and therefore such policies are also called "honour policies."

8. **Lost or not lost policy** (Sec. 8). This is a policy whereby the subject-matter is insured "lost or not lost". The insurer insures the goods irrespective of the fact whether they are already lost or not before the issue of the policy. Sometimes it happens that a merchant receives information of the shipment of his cargo very late after the sailing of the steamer and, therefore, when he submits the risk to the underwriter and effects insurance it is not known whether the subject-matter to be insured is lost or safe on that date. Hence to provide him with full protection for such shipments, the insurer issues a "lost or not lost" policy, which has a retrospective effect to provide for any loss which might have occurred during the period between the date of shipment and the date of the issue of the policy. It should be noted that if at the time of effecting the insurance, the assured knew of the loss and the insurer did not know, it would amount to

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fraudulent concealment of facts and the policy will be void (neither claim nor premium is repayable). Further, if the insurer knew of the safe arrival of cargo at the port of destination at the time of effecting the insurance, the policy will be void and the premium is returnable.

Insurable Interest

The assured must have "insurable interest"[8] in the subject-matter of the insurance, otherwise the contract of insurance will be a wagering agreement which shall be void *ab-initio.* A person is said to have an insurable interest in the subject-matter when he stands in any legal or equitable relation to the subject-matter in such a way that he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, damage or detention, or may incur liability in respect thereof (Sec. 7).

Since marine insurance is frequently effected before the commercial transactions, which form the subject-matter of insurance, are formally completed, it is not essential for the assured to have an insurable interest at the time of effecting the insurance, though he should have an expectation of acquiring such an interest and must actually acquire the interest in due course before the loss or damage, if any, takes place. If he fails to acquire insurable interest until the happening of loss or damage, the policy becomes void, being in the nature of a wager, and the assured loses all rights under the policy. Section 8, thus, declares that "the assured must be interested in the subject-matter insured at the time of the loss, though he need not be interested when the insurance is effected".

Persons deemed to have insurable interest. The owners have insurable interest in the property or goods insured upto the full value of the subject-matter. It is not, however, the owner alone who has an insurable interest, but every such person possesses an insurable interest who has something at stake or something to lose by the happening of the peril insured against. The following persons are deemed to have insurable interest in the marine adventure and thus can insure:

1. The insurer or underwriter has an insurable interest in respect of risk underwritten by him, and he may reinsure the said risk (Sec. 11).

2. The lender of money of *bottomry bond* (on the security of the ship during voyage) or *respondentia bond* (on the security of the cargo) has an insurable interest in respect of the loan (Sec. 12).

3. The master or any member of the crew of a ship has an insurable interest in respect of his wages (Sec. 13).

4. In case of advance freight, the person advancing the freight has an insurable interest, insofar as such freight is not repayable in case of loss (Sec. 14).

[8]For meaning of "insurable interest," refer to Ch. 31, Heading: *"Fundamental Principles of Insurance Contracts".*

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5. The assured has an insurable interest in the charges of any insurance which he may effect (Sec. 15).

6. Where the subject-matter insured is mortgaged, the mortgagor has an insurable interest in the full value thereof, and the mortgagee has an insurable interest in respect of any sum due or to become due under the mortgage [Sec. 16(1)].

7. A mortgage, consignee, or other person having an interest in the subject-matter insured may insure on behalf of himself as well as on behalf of and for the benefit of other persons interested therein [Sec. 16(2)]. In such a case, in the event of loss, the assured shall recover the full amount of the loss but shall, however, hold the amount above the value of his loss, in trust, for the person entitled thereto.

8. The owner of insurable property has an insurable interest in respect of the full value thereof, notwithstanding that some third person may have agreed to be liable to indemnify him in cass of loss [Sec. 16(3)].

Measure of Insurable Value

'Insurable value' is the amount of the valuation of the insurable interest for the purpose of indemnifying the assured in the event of loss. It should be distinguished from the "insured sum" or the "policy amount". It is not necessary to mention the *insurable value* in the policy, whereas the *insured sum* must be given in the policy. If insurable value is mentioned in the policy, then the policy is called a "valued policy."[9] and if this value is not mentioned, then the policy is called an "unvalued policy".[10] In the case of "unvalued policies" insurable value is determined, when the loss takes place, in accordance with the rules laid down by Section 18 of the Marine Insurance Act, which are as follows:

1. In insurance on *ship,* the insurable value is the value at the commencement of the risk; of the ship (including her outfit, machinery, fuels and engine stores, *etc.*), plus the charges of insurance upon the whole.

2. In insurance on *freight,* whether paid in advance or otherwise, the insurable value is the gross amount of the freight at the risk of the assured, plus the charges of insurance.

3. In insurance on *goods or merchandise,* the insurable value is the 'prime cost' of the property insured, plus the expenses of and incidental to

[9]The meaning of a "valued policy" has already been explained under the heading *"Kinds of Marine Policies"* in the present Chapter.

[10]An "Unvalued Policy" has already been explained under *"Kinds of Marine Policies"* in the present Chapter.

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shipping and the charges of insurance upon the whole.

4. In insurance on *any other subject-matter,* the insurable value is the amount at the risk of the assured when the policy attaches, plus the charges of insurance.

Warranties in a Contract of Marine Insurance

A warranty is an undertaking by the assured that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or that a particular state of facts does or does not exist [Sec. 35(1)]. The object of inserting warranties is to guard and protect the insurers against any increase in the risk during the period of insurance. A warranty must be exactly complied with, whether it be material to the risk or not. If it is not so complied with then, subject to any express provision in the policy, the insurer is discharged from liability as from the date of breach of warranty, but without prejudice to any liability incurred by him before that date [Sec. 35(3)]. Breach of warranty, whether committed innocently or intentionally makes the contract of marine insurance void and inoperative, and absolves the insurer from all liability as from the date of breach. It is important to note that where a warranty is broken, the assured cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss [Sec. 36(2)].

When breach of warranty is excused? According to Section 36, non-compliance with a warranty is excused in the following cases: *(i)* when, by reason of a change of circumstances (which are beyond the control of the assured), the warranty ceases to be applicable to the circumstances of the contract; or *(ii)* when compliance with the warranty is rendered unlawful by any subsequent law; or *(iii)* when a breach of warranty is expressly waived by the insurer. .

Kinds of warranties [Sec. 35(2)]. There may be two kinds of warranties, namely:

(a) Express warranties, and

(b) Implied warranties.

Express warranties. They are those which are expressly stated in the policy. There may be any number of such warranties. Usually they include: *(a)* time of sailing; *(b)* neutrality of the ship and cargo during the voyage; *(c)* the place of loading and unloading cargo; *(d)* sailing with convoy (*i.e.,* ships of war guarding a fleet of merchant vessels) during war; and *(e)* seaworthiness of the ship.

Implied warranties. These are not mentioned in the policy at all but are assumed to have been included in the policy by law or custom, and bind the parties to the contract as fully as express warranties. Such warranties

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include: (1) documentation of the ship; (2) seaworthiness of ship; (3) legality of the voyage; (4) no change of voyage; (5) no delay in voyage; and (6) non-deviation from the route prescribed. We shall now discuss these warranties one by one.

1. *Documentation of the ship.* When a ship is expressly warranted neutral, there is an implied warranty that she shall carry the necessary documents to establish her neutrality (Sec. 38).

2. *Seaworthiness of ship* (Secs. 41 and 42). This warranty applies only to 'voyage policies' and there is no implied warranty of seaworthiness in 'time policies.' This warranty implies that the ship should be seaworthy at the commencement of the voyage. If the voyage is carried out in stages, the warranty must hold good at the commencement of each stage. A ship is deemed to be seaworthy when she is reasonably fit in all respects to encounter the ordinary perils of the seas of the adventure insured. This means that the ship must be suitably constructed, properly equipped and manned, sufficiently fuelled and provisioned, and must also not be overloaded or badly loaded. Further, the ship must also be 'cargo-worthy', *i.e.,* she must be reasonably fit and suitable to carry the kind of cargo insured upto the destination contemplated by the policy, at the commencement of the voyage. Thus, 'seaworthiness' also includes 'cargo-worthiness'.

It may be noted that the warranty of seaworthiness attaches only upto the time of the sailing of the ship. Once the ship sails, this warranty does not operate. Where the policy relates to a voyage which is performed in different stages, the warranty must hold good at the beginning of each stage.

3. *Legality of the voyage* (Sec. 43). This warranty implies that the adventure insured is a lawful one, and that, so far as the assured can control the matter, the adventure shall be carried out in a lawful manner. This means that the ship must not be used for undertaking any illegal voyage or venture, *e.g.,* trading with enemy, smuggling, etc. The assured can have no right to claim a loss if the voyage or venture was illegal. Thus, for a valid marine policy the ship should undertake voyage to a friendly country and should carry lawful merchandise.

4. *No change of voyage* (Sec. 47). When the destination of the ship is changed intentionally after the commencement of the risk, there is said to be a change of voyage. There is an implied warranty that there shall be no change of voyage. Hence, where there is a change of voyage, the insurers is discharged from liability as from the time of change, that is to say, as from the time when the determination to change the voyage becomes evident or apparent, and it is immaterial that the ship may not in fact have left the course of voyage contemplated by the policy when the loss occurs.

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5. *No delay in voyage* (Sec. 50). This warranty applies only to 'voyage policies'. This warranty implies that there should be no unjustified delay in prosecuting the voyage. If, without lawful excuse, the voyage is not prosecuted throughout its course with reasonable despatch, the insurer is discharged from liability as from the time when the delay became unreasonable.

6. *Non-deviation from the route prescribed* (Secs. 48 and 49). There is also an implied warranty that the ship should not deviate from the specified route of the voyage, or where no route is specified, she should not deviate from the usual and customary route. Where several ports of discharge are specified by the policy, she must proceed to them in the order specified. Where the policy is to 'ports of discharge' within a given area, which are not named, the ship must proceed to them, or such of them as she goes to, in their geographical order. It, without lawful excuse, there is a breach of this warranty, the insurer is discharged from liability as from the time of actual deviation, even though the ship may have regained her route before any loss occurs. It may be noted that the intention to deviate is immaterial; there must be a deviation in fact to discharge the insurer from his liability under the contract.

When deviation or delay is excused? Section 51 provides that deviation or delay in prosecuting the voyage contemplated by the policy is excused under the following circumstances:

(a) where it is authorised by any special term in the policy; or

(b) where it is caused by circumstances beyond the control of the captain of the ship and his employer, *e.g.,* deviation caused due to rough weather, storm, cyclone, *etc*; or

(c) where it is reasonably necessary in order to comply with an express or implied warranty, *e.g.,* to take the ship to the nearest port in order to make the ship seaworthy; or

(d) where it is reasonably necessary for the safety of the ship or subject-matter insured, *e.g.,* from going into the hands of 'pirates' or 'State enemies'; or

(e) where it is necessary for the purpose of saving human life or aiding a ship in distress where human life may be in danger; or

(f) where it is reasonably necessary for the purpose of obtaining medical or surgical aid for any person on board the ship; or

(g) where it is caused by the 'barratry,"[11] if it be one of the perils insured against.

[11]*Barratry* means wrongful acts wilfully committed by the captain or crew in contravention of their duties, thereby causing prejudice to the owners, *e.g.,* intentionally running aground the ship.

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When the cause excusing the deviation or delay ceases to operate, the ship must resume her course and prosecute her voyage with reasonable despatch [Sec. 51(2)].

Assignment of Policy (Secs 52 and 53)

A marine policy may be transferred by assignment unless it contains terms expressly prohibiting assignment. It may be assigned either before or after loss. The assignment may be made either by a writing endorsed on the policy or in other customary manner. The insurer or underwriter need not be informed at all, that is, even notice to him is not necessary. A marine policy stands assigned automatically by operation of law to the heirs of the assured in the event of his death (Sec. 17).

Before the occurrence of any loss, a marine policy can be validly assigned only if the following two conditions are fulfilled:

1. The assignor must possess an insurable interest in the subject-matter insured at the time of assignment. An assured who has parted with or lost his interest in the subject-matter insured cannot make a valid assignment.

2. The assignee must have acquired some interest in the subject-matter insured either as buyer or mortgagee, because for a valid claim against the insurer the assignee must have an insurable interest in the property insured at the time of loss, for otherwise he cannot be indemnified.

After the occurrence of loss, the policy can be assigned in writing to any person freely, just like an actionable claim, because in such a case it means that the assignor has transferred his own right of claim to the assignee.

Where a marine policy has been validly assigned, the assignee is entitled to sue thereon in his own name, subject to any defences which would have been available against the person who effected the policy, *e.g.*, non-disclosure of material facts, *etc.*

The Premium

Unless otherwise agreed, the duty of the assured or his agent to pay the premium, and the duty of the insurer to issue the policy to the assured or his agent, are concurrent conditions, and the insurer is not bound to issue the policy until payment or tender of premium (Sec. 54).

Sections 82-84 of the Marine Insurance Act lay down the circumstances for the return of premium received, *e.g.*, where the premium or a proportionate part thereof is declared by the said Act to be returnable; where the policy contains a stipulation for the return of the premium on the happening of a certain event and that event happens; where the consideration for the payment of the premium totally fails, and there has

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been no fraud or illegality on the part of the assured or his agents; where the assured has over-insured under an 'unvalued policy', a proportionate part of the premium is returnable.

MARINE LOSSES

The principle of causa proxima. We have already discussed the principle of *causa proxima* in Chapter 31, while discussing the Fundamental Principles of Insurance Contracts. In brief, this principle means that 'in deciding whether the loss has arisen through any of the risks insured against, the proximate or the nearest cause ought to be considered'. The principle is most rigorously applied to the contract of marine insurance, for in this type of insurance there are great chances of a succession of causes leading to a loss, some of which may not be insured against. If the proximate or the nearest cause of losses or damage is one which is insured against, then only the insurer is liable. The insurer is not liable for remote causes and remote consequences.

ILLUSTRATIONS. *(a)* In a marine policy, the cargo was a shipment of oranges. The peril insured against was collision with another ship. During the course of the voyage there was a collision, resulting in delay and mishandling of shipment which made oranges unfit for human consumption. It was held that the loss was due to mishandling and delay and not due to collision, which was a remote cause, though without it no mishandling or delay was necessary, and therefore the insurer was not liable *(Pink* vs *Fleming*[12]*)*.

(b) A ship carrying meat was delayed by storm. It consequence of which the meat became decomposed and had to be thrown overboard. It was held that loss of meat was not a loss by the perils of the sea, the proximate cause being delay, although the delay was caused by a peril insured against *(Taylor* vs *Dunbar*[13]*)*.

(c) In a marine policy, the goods were insured against damage by sea-water. The goods were damaged and it was found out that rats had made a hole in the bottom of the ship which resulted in the entry of sea-water and loss to the goods. The underwriters contended that as they had not insured against the damage by rats, they were not bound to pay. It was held that proximate cause of damage being sea-water, the insured was entitled to damages, the rats being a remote cause. 'How the sea-water entered is of no relevance, so long as the proximate cause of loss is sea-water the insurers are liable' *(Hamilton* vs *Pandrof*[14]*)*.

Thus, in deciding whether the loss has arisen through any of the risks insured against, the proximate or the last of the causes is to be looked into and others rejected. The Marine Insurance Act, 1963, specifically provides to the same effect. Section 55 lays down that unless the policy otherwise

[12](1899), 25 Q.B.D. 396
[13](1869), 38 L.J.C.P. 178.
[14](1887), 12 App. Cas. 518.

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provides, the insurer is liable for any loss proximately caused by a peril insured against, but, subject to as aforesaid, he is not liable for any loss which is not proximately caused by a peril insured against. The Section further proves that:

(a) the insurer is not liable for any loss attributable to the *wilful misconduct of the assured,* but, unless the policy otherwise provides, he is liable for any loss proximately caused by a peril insured against even though the loss would not have happened but for the misconduct or negligence of the master or crew;

(b) unless the policy otherwise provides, the insuer on ship or goods is not liable for any loss proximately caused *by delay,* although the delay be caused by a peril insured against;

(c) unless the policy otherwise provides, the insurer is not liable for *ordinary wear and tear,* ordinary leakage and breakage, *inherent vice* or nature of the subject-matter insured, or for any loss proximately caused by *rats or vermin,* or for any injury to machinery not proximately caused by the marine perils.

Kinds of losses. Broadly speaking, marine losses may be of two types: (1) total loss, or (2) partial loss [Sec. 56(1)].

Total Loss

When the subject-matter of insurance (the ship, cargo, freight, *etc.*) is totally lost, it is known as a *'total loss'*. A total loss may be either *(a)* actual total loss, or *(b)* constructive total loss [Secs. 56(2)].

(a) **Actual total loss.** Section 57(1) defines an actual total loss as having occurred when the subject-matter insured is destroyed, or so damaged as to cease to be a thing of the kind insured, or where the assured is irretrievably deprived thereof. The following are the example of actual total loss:

(i) when the subject-matter insured is totally destroyed or reduced to ashes; or

(ii) when it is so damaged that it has changed its nature and has become a thing of a different kind, *e.g.,* cement converted into stone, or sugar converted into sarbat, or hides converted into manure; or

(iii) when the assured has irretrievably been deprived of it, *e.g.,* ship captured by pirates or enemy; or

(iv) where the ship is missing, and after the lapse of a reasonable time no news of her has been received, an actual total loss my be presumed (Sec. 58).

In each of these cases, the underwriter must pay the full insured sum or the actual loss, whichever is lesser, provided that the cause of the loss was one of the perils insured against.

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It may be noted that no *'notice of abandonment'* need be given to the insurer in the case of an actual total loss [Sec. 57(2)].

(b) **Constructive total loss.** When the subject-matter of insurance is not destroyed in fact, but is treated as destroyed by a rule of law for all practical purposes, it is known as a *constructive total loss.* Such loss arises when the ship or cargo is reasonably abandoned and taken as lost because the expenses of preserving or salvaging the object would exceed the value of the thing when repaired or recovered (Sec. 60). Thus, there is a constructive total loss where the ship is sunk in deep water and cannot be raised without expenditure in excess of its value, *or* the cargo is so damaged that the cost of reconditioning and the expenses incidental to it are greater than the sum which would be realised by its sale after reconditioning.

In *Moss* vs *Smith,*[15] Maul J. explained the *doctrine of constructive total loss* in these words: "A man may be said to have lost a shilling when he has dropped it into deep water, though it might be possible by some very expensive contrivance to recover it. The shilling exists and it could be recovered at price, but what man would be foolish enough to spend, say 100 shillings, in order to recover one. The saner course would be abandon the shilling in the deep water and regard the loss as *constructive total loss."*

In the case of constructive total loss also the underwriter is liable to pay the full insured sum or the actual loss, whichever is lesser, to the assured. But in order to make the insurer liable *'notice of abandonment'* must be given to him by the assured within reasonable time. If the assured fails to give this notice, the loss shall be treated as a 'partial loss' [Sec. 62(1)].[16]

Notice of abandonment (Secs. 62 and 63). It is a notice by the assured to the insurer whereby, in the event of constructive total loss the assured declares that he abandons his interest in the insured property unconditionally to the insurer. The notice may be given in writing or by word of mouth but it must be given with reasonable diligence after the receipt of reliable information of the loss.

The acceptance of an abandonment may be either express or implied from the conduct of the insurer. The mere silence of the insurer after notice is not an acceptance. Where the insurer refuses to accept a properly made abandonment, the rights of the assured are not prejudiced in any way. Of course, in that case it will be necessary for the assured to take the help of court of law to recover the loss. Where the notice of abandonment is accepted, the abandonment is irrevocable and, the insurer pays the total loss and realises what he can from the property which has been abandoned to him.

[15](1845), 2 B.B. 94.

[16]Under certain circumstances *notice of abandonment* is not necessary. Such circumstances have been discussed under the next heading.

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In the following cases, however, no notice of abandonment need be given by the assured:

(i) Where at the time when the assured receives information of the loss, there would be no possibility of benefit to the insurer if notice were given to him.

(ii) Where the insurer has expressly waived the notice of abandonment.

(iii) Where the insurer has reinsured his risk.

Partial Loss

When the subject-matter of insurance is only partially lost, it is known as *'partial loss'* or 'average loss'. A partial loss may be either *(a)* general average loss, or *(b)* particular average loss.

(a) **General average loss** (Sec. 66). A *general average loss* is a loss caused by a general average act. There is a general average act where any extraordinary sacrifice or expenditure is voluntarily and reasonably made or incurred in time of peril with a view to protecting the common interest of all owners in marine voyage and enabling the ship to proceed safely with her journey. Examples of general average acts or losses are:

(i) jettisoning (throwing overboard) of cargo for lightening the ship, during a storm or when the ship has run aground, with a view to saving the ship and the remaining cargo;

(ii) damage caused by water used in extinguishing fire in a ship;

(iii) money paid to pirates for the purpose of saving both ship and cargo;

(iv) loss arising through burning of cargo as fuel due to shortage of normal fuel under extraordinary circumstances.

Thus, the following conditions must be fulfilled before general average loss arises:

(a) the peril must actually exist;

(b) the danger must be common to all who are called upon to contribute;

(c) some extraordinary sacrifice or expenditure must be made or incurred; and

(d) the sacrifice or expenditure must be done voluntarily (and not caused accidentally) and prudently for the general security and protection of the marine adventure in peril.

Where there is a general average loss, the party on whom it falls is entitled to a general average contribution, *i.e.*, to a rateable contribution from all the parties interested and the shipowner, in accordance with the "York Antwerp Rules" (a code of rules relating to the adjustment of general average loss). However, the seamen who were interested in the safety of the ship for their wages will not be required to contribute any part of their

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wages towards general average contribution.

In case the marine insurance policy covers the 'general average loss,' the assured is entitled to recover from the insurer in respect of the general average contribution which he has to pay on account of general average loss. In case the insured goods are jettisoned for general safety, the assured (owner of the jettisoned goods) is entitled to recover from the insurer in respect of the whole loss without having enforced his right of contribution from the other parties liable to contribute. Of course, after paying the total loss to the assured (owner of the jettisoned goods), the insurer steps into his shoes and becomes entitled to general average contribution for the jettisoned goods from all other parties interested.

(b) **Particular average loss.** A partial loss of the subject-matter insured which is caused by a peril insured against but which is not a general average loss is known as a *'particular average loss'* [Sec. 64(1)]. Thus, the basic essential of a *particular average loss* are as follows:

(i) It must be accidentally caused by a peril insured against, and must not be suffered voluntarily.

(ii) It must concern solely the owner of the goods, and must not be suffered for the general safety of the ship or cargo. In other words the loss must fall entirely upon the party interested in the subject-matter lost or damaged, and the question of contribution from other parties interested in the adventure should not arise.

ILLUSTRATION. If some tins of milk powder are shipped, and a few of them are damaged by sea water in transit, the loss would be regarded as a 'particular average loss,' and the partial loss in this case would be borne alone by the owner of the cargo, or if insured, by the insurer of the cargo.

If 'particular average loss' is covered in the case of *insurance on ship* then the insurer is liable for all *successive losses,* subject to the amount of policy for any single repair, even through the total amount of such losses may far exceed the sum insured. But where a partial loss, which has not been repaired or otherwise made good, is followed by a total loss, the assured can only recover in respect of the total loss (Sec. 77). Where the policy contains a 'suing and labouring clause; whereby all expenses incurred by the assured or his agents or servants in mitigation of losses after the casualty has occurred are payable by the insurer; the assured may recover from the insurer any expenses properly insured pursuant to the clause, notwithstanding the insurer may have paid for a total loss. (Sec. 78.)

Rights of Insurer on Payment

An insurer has the following rights on payment:

1. **Right of subrogation** (Sec. 79). Where the insurer pays for a *total*

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loss; either of the whole *or* of any apportionate part in the case of goods; of the subject-matter insured, he has a right of subrogation by which he becomes entitled to take over the interest of the assured in whatever may remain of the subject-matter so paid for, and also to all the rights and remedies of the assured with regard to that subject-matter as from the time of the casualty causing the loss. But where the insurer pays for a *partial loss*, he acquires no title to the property insured or such part of it as may remain, though he is thereupon subrogated to all rights and remedies of the assured with regard to that property against third parties. (For more details about the *doctrine of subrogation,* refer to Chapter 31 — side-heading: 'Fundamental Principles of Insurance Contracts').

2. **Right of contribution** (Sec. 80.). Where the assured is over-insured by double insurance, each insurer is bound, as between himself and the other insurer, to contribute rateably to the loss in proportion to the amount for which he is liable under his contract. If any insurer pays more than his proportion of the loss, he is entitled to maintain a suit for contribution against the other insurer, and is entitled to the like remedies as a surety who has paid more than his proportion of the debt. (*The doctrine of contribution* has already been discussed in detail in Chapter 31, under the side-heading —'Fundamental Principles of Insurance Contracts').

3. **Right in case of under-insurance** (Sec. 81). Where the assured is insured for an amount less than the insurable value of the property, he is deemed to be his own insurer in respect of the uninsured balance. Accordingly, if the property is under-insured, then the insurer has a right to demand rateable proportion of the loss from the assured. A similar right is available to the insurer under an 'average policy' of fire insurance (For details of the Average Policy, refer to Chapter 33, side-heading: 'Types of Fire Policies'.)

TEST QUESTIONS

1. Define a contract of marine insurance. What are the characteristics of such a contract?

2. What do you understand by the term 'maritime perils? What marine adventures may be the subject-matter of a contract of marine insurance?

3. Explain briefly the various kinds of marine insurance policies.

4. What does the term 'insurable interest' mean in connection with marine insurance? Who are deemed to have an insurable interest in a marine adventure? Discuss the rules relating to the measure of 'insurable value' as laid down by the Marine Insurance Act.

5. What is a 'warranty' in a contract of marine insurance? State its importance.

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What are 'express' and 'implied' warranties? When can the non-compliance with a warrantly be excused?

6. (a) What is 'deviation' as applied to a marine policy and what are its consequences? Under what circumstances is 'deviation' excused?

(b) Write a note on assignment of a marine insurance policy.

7. (a) Explain and illustrate the rule of *causa proxima* in marine insurance.

(b) Distinguish between 'general average loss' and 'particular average loss' in marine insurance.

8. Discuss fully the various kinds of 'marine losses'.

9. (a) 'A contract of marine insurance is a contract *uberrimae fidei'*. Comment.

(b) Discuss the rights of an insurer on payment, in case of marine insurance.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. A ship, which was insured under a 'time policy,' was sent to sea unseaworthy in two respects: her hull was in an unfit state for the voyage and her crew was insufficient. The assured knew of the insufficiency of the crew but not of the unfitness of the hull. The ship was lost because of the unfitness of the hull. Is the insurer liable to pay for the loss?

[Hint. Yes, the insurer is liable to pay for the loss. In a 'time policy' there is no implied warranty of seaworthiness, provided the loss is not attributable to the unseaworthiness of which the assured was having the knowledge. (*See* Implied Warranty of "Seaworthiness of the Ship" discussed under "Warranties".)]

2. A ship was insured against "perils of the sea." The ship deviated to assist another in distress, but instead of merely saving the crew, she attempted to earn salvage by towing the distressed vessel into a nearby port, and in the attempt, went ashore herself and was lost. Is the insurer liable?

[Hint. No, the insurer is not liable. Deviation to aid a ship in distress where human life may be in danger is always excused, but deviation to save property as such, with a view to earn salvage is not allowed. Hence, in the instant case, there is a breach of warranty of 'non-deviation' without a lawful excuse, as a result the insurer is discharged from liability.]

3. *P*'s cargo was damaged by fire on board a ship. During the course of extinguishing fire by water, the cargo of Q was also damaged. Can *P* or *Q* claim contributions from the owners of the other interests in the ship and cargo on the basis of "general average loss"?

[Hint. *P* cannot but *Q* can. *Q's* loss is caused by a general average act with a view to protecting the common interest of owners of the remaining cargo and the ship and, therefore, it is only he who is entitled to claim general average contribution from owners of other interests.]

4. The Captain of a ship, which was on the point of capture, threw over-board a quantity of the cargo lest it should fall into enemy hands. The marine policy covers the "general average loss". The ship ultimately escaped capture. Is the

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insurer liable to the owners of the cargoes, whose cargoes were thrown overboard?

[**Hint.** No, the insurer is not liable as the loss in the instant case cannot be called as a "general average loss" because the sacrifice was neither prudently made nor the object of the sacrifice can be said to be the preservation of the property in peril in common adventure and enabling the ship to proceed safely with her journey. However, the captain or the owner of the ship is liable to indemnify the owners, whose cargoes were thrown overboard.]

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PART VI

Law of Insolvency

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Chapter 35

Objects and Scope of the Insolvency Law

The Law of Insolvency in India is contained in two enactments, namely, *(i)* the Presidency Towns Insolvency Act, 1909,[1] which applies to the Presidency Towns of Calcutta, Madras and Bombay, and *(ii)* the Provincial Insolvency, Act, 1920,[2] which applies to the whole of India except the Presidency Towns mentioned above. The body of the law as laid down in the two Acts is almost similar excepting the differences between them on some matters relating to procedure. We shall be seeing the differences at appropriate places during the course of our discussion. The procedure under the Presidency Act is generally stricter than the Provincial Act.

Both the Presidency Towns Insolvency Act and the Provincial Insolvency Act are based on the English Law of Bankruptcy.

Insolvent Defined

The term 'insolvent' has not been defined by the Acts on the subject. The term, however, refers to a person who cannot or does not pay his debts in full or has committed an "act of insolvency."[3] and has been adjudged an insolvent by an Insolvency Court. It is worth noting that default by a debtor, *i.e.,* not paying on due date because of insufficiency of assets to meet all the claims, is not the only cause leading to the insolvency of a debtor. Even if there is sufficient property to pay, or even before the maturity date, a debtor can be declared insolvent on a petition by a creditor, if he deals with

[1]The Pres. T. Ins. Act, 1909, has been amended in 1914, 1920, 1926, 1927, 1929, 1930 and so far as Bombay Presidency alone is concerned by Bombay Acts of 1939 and 1948. The Act has been further amended by the Insolvency Laws (Amendment) Act, 1978, which came into force from 1 September 1979.

[2] The Prov. Ins.Act, 1920, has been amended in 1926, 1927, 1935, and so far as Bombay Presidency alone is concerned by the Bombay Act of 1948. It has been further amended by the Insolvency Laws (Amendment) Act, 1978, which came into force from 1 September 1979.

[3]For details see the side heading: *"Acts of Insolvency"* given later in this Chapter.

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his property in strange and suspicious manner, which amounts to an "act of insolvency" as per law. In short, therefore, 'insolvent means a person against whom an "order of adjudication" has been passed.

The terms 'insolvent' and 'insolvency' as used in Indian Law are synonymous with the terms 'bankrupt' and 'bankruptcy' of English Law.

Objects of Insolvency Laws

Prior to the enactment of insolvency legislation, a debtor who was unable to pay debts was regarded as a sort of criminal or offender and was, in almost every case, sent to jail. No distinction was drawn between *honest and unfortunate debtors* on the one hand and *dishonest debtors* on the other. Whether the inability to pay arose from misfortune or was brought about by fraud or recklessness, they were all committed to prison to remain there at the mercy of their creditors until the debt was paid. It was realised in course of time that sending an honest but unfortunate debtor to jail is oppressive and unprofitable. Thus, insolvency laws were passed to relieve the honest debtor, who surrenders for distribution amongst his creditors the property which he owns at the time of bankruptcy, from the weight of oppressive indebtedness, and permit him to start afresh in life free from the pressure and discouragement of pre-existing debts consequent upon business misfortunes.

The primary objects of the insolvency laws may thus be stated as follows:

(i) To free an honest and unfortunate debtor from his debts when he has made a full surrender of his property for distribution among his creditors, so that he can make a fresh start as soon as he is discharged by the court.

(ii) To safeguard, as far as possible, the interests of creditors by compelling the insolvent to give up all his property to their use, without any fraudulent concealment, so that the same may be distributed among the creditors in the most expeditious, the most equal, and the most economical mode.

In this regard Blackstone comments: "The laws of bankruptcy are considered as laws calculated for the benefit of trade, and founded on the principles of humanity as well as justice, and to that end they confer some privileges, not only on the creditors, but also on the bankrupt or debtor himself."

Procedure. With a view to achieving the objectives stated above, the insolvency laws lay down *(i)* the procedure by which a person can be declared insolvent, and *(ii)* the rules to be followed in distributing the properties of an insolvent among his creditors in an equitable manner. Accordingly, the insolvency proceedings are started by a petition filed either by the debtor or a creditor of the debtor for the adjudication of the

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debtor as insolvent. On such petition the debtor is adjudged insolvent by the court provided he has committed an 'act of insolvency'. On such adjudication, the properties of the insolvent stand vested in an officer of the court known as the Official Assignee (in case of the Presidency Act) or the Official Receiver (in case of the Provincial Act) and become divisible among the creditors. The Officer, after being satisfied about the genuineness of the claims of the creditors, distributes the insolvent's property rateably among his creditors. When the work of distribution is completed, the insolvent is required to obtain a certificate of 'absolute discharge' from the court, which is granted only when it is proved that insolvency was caused by misfortune and not by the misconduct of the insolvent and that the conduct of the insolvent has been satisfactory during the insolvency proceedings. On obtaining the 'absolute discharge certificate', the unpaid debts (except certain specified debts,[4] *e.g.,* government debts) are cancelled and the person of the insolvent debtor is liberated from the demands of his creditors, and the insolvent is afforded a new opportunity in life and a clear field for future effort like an ordinary citizen.

It is to be noted that from the date of the 'order of adjudication' to the date from which the 'order of discharge' operates, the insolvent debtor is an 'undischarged insolvent,' and the creditors can always ask him through the court or the Official Assignee to pay the unpaid balance if he happens to possess some fortune again before the court passes the 'order of absolute discharge'. Hence it is only after an 'absolute discharge order' is passed that the unpaid debts are cancelled and the insolvent gets a fresh start in life. It may further be noted that although an undischarged insolvent cannot transact relating to his properties *(i.e.,* cannot sell or transfer his properties —both pre-existing and after acquired) which now vests in the Official Assignee/Receiver, but he is not deprived of his contractual capacity by being declared an insolvent and he can still incur debts and acquire properties (if some fool likes to sell him). He may also seek an employment, of course salary earned by him must be handed over to the Official Assignee/Receiver, except for such portion which may be allowed for his subsistence.

Insolvency Courts

An Insolvency Court means a court having jurisdiction (legal authority) to decide insolvency petitions. The courts having jurisdiction under the Presidency Towns Insolvency Act are the High Courts of Calcutta, Madras and Bombay. The Courts having jurisdiction under the Provincial Insol-

[4]These exceptions shall be discussed later in detail in Chapter 38—'Discharge of Insolvent', under the side-heading: *Effect of Order of Discharge.*

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vency Act are the District Courts, but the State Government may, by notification in the Official Gazette, invest any court subordinate to a District Court, including a court of Small Causes, with insolvency jurisdiction. Any court so invested shall within the local limits of its jurisdiction have concurrent jurisdiction with the District Court and as such either court shall have jurisdiction to entertain an insolvency petition within its local limits.

Insolvency Courts have full powers to decide all questions whatsoever, whether of law or fact, or whether of title or priority, which may arise during the course of any insolvency proceedings, and a second suit would not lie in respect of the same matter in the ordinary civil courts. However, orders in insolvency matters are appealable to a higher court at the instance of any person aggrieved.

Who may be Adjudged Insolvent?

In general, any person, who can be made personally liable for contracts entered into by him, may be adjudged an insolvent, provided:

(i) he is a 'debtor' within the meaning of the insolvency Law, *i.e.,* he owes money to others and is subject, either by birth and natural allegiance, or by temporary residence, to the laws of India; and

(ii) he has committed an 'act of insolvency'.[5]

Certain special cases are discussed below:

1. **Minor.** A minor is absolutely incompetent to contract so as to incur any personal liability under any circumstances. Even where necessaries are supplied to a minor, his property and not his person is liable for the payment of the price. Since a minor cannot be a debtor, he cannot be adjudged insolvent.

2. **Lunatics.** The position of a lunatic is similar to that of a minor. He cannot also be adjudged an insolvent. But he may be adjudged an insolvent, if he has contracted the debt and committed an 'act of insolvency' during a lucid interval of sanity or while he was sane (prior to his lunacy).

3. **Married woman.** A married woman possessing separate property may be adjudged insolvent in respect of debts contracted by her.

4. **Foreigner.** A foreigner can be adjudged insolvent by a court in India only if he has committed an 'act of insolvency' during his personal residence in India. Personal residence is a must. A non-resident foreigner (who had never resided in India) cannot be adjudged an insolvent, even though he has been carrying on business in India through an agent and incurs debts and commits an 'act of insolvency' *(Ganeshnarayan* vs *Pratapgiri*[6]*)*. It should be noted that if the 'act of insolvency' was committed during his

[5]For details, *see* next heading: *'Acts of Insolvency'*.
[6]40 Bom. L.R. 33.

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personal residence, it is not necessary that he should be personally present in India at the time of the presentation of the petition against him.

5. **Joint debtors.** A creditor is entitled to present a single petition against two or more joint debtors provided each one of them is guilty of committing an 'act of insolvency.' If only one of the joint debtors has committed an 'act of insolvency,' he alone can be adjudged insolvent if the creditor wants to make him liable.

6. **Partnership firm and partners.** An order of adjudication can be made against a firm in the firm's name, which will be equivalent to the adjudication of all the partners (except a minor partner, if any) as insolvent, provided each of the partners have committed an 'act of insolvency.' It is so because a partnership firm has no separate entity distinct from that of its individual partners. So far as individual partners are concerned, no partner can be adjudged insolvent unless he himself has committed an 'act of insolvency.' A single petition may, however, be presented against two or more partners, the liability of each partner being joint and several for any debt due on the firm.

7. **Joint Hindu Family.** Usually, only the *Karta* of the family is personally liable for the debts contracted by him in the course of the business, and hence can be adjudged an insolvent. The other members of the family are not personally liable for the debts and they cannot therefore be adjudged insolvent in respect of joint family debts, unless they render themselves personally liable by taking an active part in the business or otherwise *(Nagasubramanya* vs *Krishnamachariar*[7]*)*. The members of a joint Hindu family may, however, be adjudged insolvents on a single petition of a creditor, if they are personally liable on a joint debt and have committed jointly or severally an 'act of insolvency.' The creditor cannot, of course, join the minor members of the family in the petition.

8. **Incorporated companies.** Companies incorporated under the Companies Act or registered under any other enactment for the time being in force cannot be adjudged insolvent (See Secs. 107 and 8 respectively of the PTI Act and the PI Act). Where a company is in insolvent circumstances, the only course open to creditors of such a company is to file a winding up petition against it under the Companies Act.

9. **Deceased person.** A deceased person cannot be adjudged an insolvent even if the insolvency petition was presented before his death. On receiving an insolvency petition, the court may pass an 'order for the administration of the estate of the deceased debtor in insolvency,' as a result of which the property of the deceased shall vest in Official Assignee/

[7](1927), Mad. 981.

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Receiver and will be distributed among the creditors pro-rata as if it were an insolvent's estate.

10. **Legal representatives.** A legal representative is not personally liable for the debts of the deceased debtor and therefore cannot be adjudged insolvent for the debts of the deceased. The deceased's estate is liable for his debts.

11. **Convicts**. A convicted criminal can be adjudged insolvent.

Acts of Insolvency

An 'act of insolvency' is 'some act of the debtor which shows that he is financially embarrassed.' As stated earlier, a person cannot be adjudged insolvent unless: *(i)* he is a 'debtor' within the meaning of the insolvency Law, and *(ii)* he has committed an 'act of insolvency'.

The 'acts of insolvency' are laid down by Section 9 of the Presidency Towns Insolvency Act, and Section 6 of the Provincial Insolvency Act. They are, with certain exceptions, practically the same. According to both the Acts, a debtor commits an 'act of insolvency' in each of the following cases:

1. If, in India or elsewhere, he makes a transfer of all or substantially all his property to a third person *for the benefit of his creditors generally.*

A transfer of all or substantially all the property, although it is for the benefit of the creditors generally, is treated as an act of insolvency because the debtor thereby attempts to put his property into a course of distribution different from that which would take place under the provisions of the Insolvency Acts. For a transfer, under this clause, to constitute an act of insolvency it is necessary that the transfer of property must be 'for the benefit of the creditors generally', that is to say, the creditors must get certain rights under the transfer which they will be in a position to enforce as against the transferee. It is not necessary to prove an intent on the part of the debtor to defeat or delay creditors.

Those creditors who have consented for such transfer cannot apply for adjudication of the debtor on this ground. Any such transfer of property is void as against the Official Assignee or Receiver, if the debtor is adjudged insolvent within three months of transfer and the transferee will have to hand over the property to the Official Assignee or Receiver, as the case may be.

2. If, in India or elsewhere, he makes a transfer of his property or any part thereof, *with intent to defeat or delay his creditors.*

In this case, unlike the first case, the transfer need not be of the whole or substantially the whole of the debtor's property, it may be of a part only of it. Again, unlike the first case, the transfer need not be in favour of creditors generally, it may be in favour of any person whosoever. But it is

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necessary to prove that the primary intention of the transfer was 'to defeat or delay the creditors.' The debtor's dishonest or fraudulent intention must be proved. Such an intention may be gathered *(i)* from surrounding circumstances and *(ii)* from debtor's act. Thus, for example, on the eve of insolvency, if the whole or substantially the whole of the debtor's property is transferred by way of gift, or, if the transfer is only a nominal transfer *(benami transaction)* where the transferee, though the legal owner, is simply a *sham holder* for the benefit of the debtor with a view to shielding his properties from his creditors, the presumption of intent to defraud or delay the creditors is immediately raised. Such transfers are usually without consideration and are known as 'fraudulent transfer.'

Any such transfer of property is void as against the Official Assignee or Receiver upon the passing of the 'order of adjudication.' No time limit is prescribed here within which the Adjudication Order should be passed from the date of transfer for making the transfer void.

3. If, in India or elsewhere, he makes any transfer of his property or any part thereof, which would, under this or any other enactment for the time being in force, be void as a *fraudulent preference* if he were adjudged an insolvent.

A 'fraudulent preference' is a transfer of property or payment made by a debtor to one or more creditors deliberately with a view to giving fraudulent preference to them over the rest of the creditors, though the transfer may be for adequate consideration. It should be noted that the preference is fraudulent only when the *dominant idea* in the mind of the debtor was to prefer one creditor over others. "There is no fraudulent preference when a debtor's dominant intention is to benefit himself rather than to confer an advantage on his creditor" *(Pennycuick J. in Re F.L.E. Holdings Ltd.*[8]*)*. Thus, payment made under pressure or threat of legal proceedings is not a fraudulent preference. 'Fraudulent preference' amounts to an act of insolvency.

If the debtor is adjudicated insolvent on a petition presented within three months of the date of transfer or payment, the transfer is void as against the Official Assignee or Receiver and the creditor so preferred must return the property, goods or money so obtained (Secs. 56 and 54 of the Pres. T. Ins. Act and the Prov. Ins. Act respectively).

4. If with intent to defeat or delay his creditors *(i)* he departs or remains out of India; *(ii)* he departs from his dwelling-house or usual place of business or otherwise absents himself; or *(iii)* he secludes himself so as to deprive his creditors of the means of communicating with him.

In order to make the various acts mentioned above the 'acts of

[8] (1967), 3 All ER 553.

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insolvency,' it is necessary to prove that the act was done *with intent to defeat or delay creditors*, whether any creditor has in fact been delayed or not is immaterial. In the absence of such intent the afore-mentioned acts have absolutely no effect. The existence or otherwise of the intention to defeat or delay creditors is a question of fact, to be decided according to the circumstances of each case. Thus, for example, where the debtor departs from India for a business trip, the departure will not constitute an act of insolvency, even if creditors are delayed thereby *(Warner* vs *Barber*[9]*)*. On the other hand, if a debtor departs from his place of business with all his available cash with a view to avoid a threatened attachment, though under a groundless misapprehension, it will be an act of insolvency *(Re Aranvayal Sabhapaty*[10]*)*.

5. If any of his property has been *sold or attached* for a period of not less than twenty-one days in execution of the decree of any court for the payment of money (Pres. T. Ins. Act). Under the Provincial Insolvency Act, it is *only a sale* of property in execution of a decree of any court for the payment of money that can operate as an act of insolvency, and attachment of debtor's property, for however long a time, is no ground for founding an insolvency petition.

It is to be noted that attachment or sale of property in execution of an 'award' made by an Arbitrator and filed in court under Section 11 of the Indian Arbitration Act, 1890, does not operate as an act of insolvency because the 'award' is not a 'court decree', although it is enforceable under that Act as if it were a decree *(Ramsahai Mull* vs *Joylal*[11]*)*.

6. If he *petitions to be adjudged an insolvent;* even if the petition is subsequently dismissed; any creditor can present an insolvency petition on this ground.

7. If he gives *notice to any of his creditors that he has suspended,* or that he is *about to suspend,* payment of his debts.

The notice may be oral or in writing, but it must convey a clear impression that the debtor has stopped payment or is about to stop payment and had no intention to pay the debt as it falls due. Further, it must be so worded that the creditors may be led naturally to infer that the debtor is suspending or stopping payments of his debts generally (*i.e.,* due to all his creditors) and not that he is suspending the payment of a particular debt (*Muniswami* vs *Rangachari*[12]).

[9](1816), Holt. N.P. 175.
[10](1897), 21 Bom. 297.
[11](1928), 32 C.W.N. 608.
[12](1937), 1 Mad. L.J. 961.

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8. If he is *imprisoned in execution of the decree* of any court for the payment of money.

An insolvency petition against a debtor founded on this act of insolvency must be presented while the imprisonment continues.

9. If he *fails to comply with an 'Insolvency Notice,'* served upon him by any one or more creditors in respect of a decree or an order for the payment of money, within the period specified in the notice which shall not be less than one month.

Insolvency notice is a stututory notice which the creditor, who has obtained a decree or order for the payment of money against the debtor, gives in a prescribed form through the Court to his debtor. It requires the debtor to pay, or furnish sufficient security for the payment of, the decretal amount within the time specified therein which shall not be less than one month. On receiving this notice the debtor either *(a)* must pay the amount, or *(b)* must give security for the payment of the amount to the creditor or his agent to their satisfaction, or *(c)* must prove that he has a counter-claim or set-off against the judgement creditor, which equals or exceeds the decretal amount and which he could not lawfully set-up in the suit in which the decree or order was made against him, or *(d)* must satisfy the Court that he is entitled to have the decree or order set-aside, or that the decree or order is not executable, under any law providing for the relief of indebtedness. If the debtor fails to pay or give security or prove his counter-claim or satisfy the Court that the decree or order is not executable, he shall be deemed by law to have committed an act of insolvency, on which a petition for adjudication may be subsequently founded.

It may be noted that prior to the commencement of the Insolvency Laws (Amendment) Act, 1978, *(i.e.,* 1 September 1979), non-compliance with an 'insolvency notice' was treated an 'act of insolvency' only in the States of Gujarat and Maharashtra.[13] The said Amendment Act 1978, by inserting sub-section (2) in each—Sec. 9 and Sec. 6 of the Presidency Towns Insolvency Act and the Provincial Insolvency Act respectively, has made this provision, subject to certain modifications, applicable to the whole of India.

Liability of principal for agent's act of insolvency. Under the explanations to the Secs. 9 and 6 of the Presidency and the Provincial Acts respectively, it has been provided that an 'act of insolvency' committed by an agent of the debtor, amounts to an 'act of insolvency' by the debtor himself, even though the agent has no special authority to commit the act.

[13]See Sections 9A and 6A of the Pres. T. Ins. Act and the Prov. Ins. Act, respectively.

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TEST QUESTIONS

1. What are the objects of the Insolvency Law? Discuss in brief the procedure relating to Insolvency in India.

2. Explain if *(a)* a minor, *(b)* a married woman, *(c)* a foreigner, *(d)* a partnership firm, *(e)* an incorporated company, and *(f)* a deceased person can be adjudged insolvent.

3. Discuss the various acts which are to be considered 'acts of insolvency' under both the Presidency Towns Insolvency Act and the Provincial Insolvency Act.

4. What is the significance of an 'act of insolvency' in the Insolvency Law? State the various 'acts of insolvency'.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *P*, an Englishman residing in England, had a place of business in Delhi. He acquired property and also incurred debts in India through an agent. Later on, he executed in England a deed transferring the whole of his property to one of his creditors with a view to giving fraudulent preference to him over the rest of the creditors. The Delhi High Court adjudicated *P* insolvent. Is the Adjudication Order valid?

[**Hint.** No, the Adjudication Order is not valid, for a foreigner cannot be adjudged insolvent by an Indian Court unless he commits an 'act of insolvency' during his personal residence in India.]

2. *A* and *B* jointly owe a debt of Rs 10,000 to C. *A*, being in financial difficulties, transfers all his property to *D* for the benefit of his creditors generally. *C* presents an insolvency petition against both *A* and *B* on that ground. Will he succeed?

[**Hint.** No, *C* will not succeed against both *A* and *B*. He can get only *A* adjudged insolvent, for if only one of the joint debtors has committed an 'act of insolvency,' he alone can be adjudged insolvent.]

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Chapter 36

Procedure of Insolvency

The Insolvency Proceedings involve a lengthy process indeed. There are four procedural stages after passing through which a debtor who has committed an 'act of insolvency' can be adjudged insolvent and can ultimately be granted a 'certificate of discharge.' These stages are:

1. Presentation of Insolvency Petition.
2. Interim Proceedings before Adjudication.
3. Passing of the Order of Adjudication.
4. Discharge of Insolvent.

Insolvency proceedings are said to be completed after going through all these stages. We shall be studying these stages one by one in the present chapter except the last stage, namely, 'Discharge of Insolvent', which forms the subject-matter of Chapter 38.

PRESENTATION OF INSOLVENCY PETITION

Court to which petition must be presented. Proceedings in Insolvency commence with the presentation of a petition in the Insolvency Court (*i.e.*, High Court under the Presidency Act or District Court under the Provincial Act) within the jurisdiction of which *(i)* the debtor, is, at the time of the presentation of the insolvency petition, imprisoned in execution of a money decree, or *(ii)* the debtor, within a year before the date of the presentation of the insolvency petition, has ordinarily, resided or has a dwelling-house or has carried on business himself or through an agent, or, *(iii)* the debtor personally works for gain, or *(iv)* in the case of a petition by or against a partnership firm of debtors, the firm has carried on business within a year prior to the date of petition (Sec. 11, Pres. T. Ins. Act). The Provincial Insolvency Act, Section 11, contains no limitations as regards the length of residence or carrying on business, *etc.*

Who may present petition? An insolvency petition may be presented *either* by one or more of the creditors (called creditor's petition) *or* by the debtor himself (called debtor's petition).

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Conditions for a Creditor's Petition

A creditor shall be entitled to present an insolvency petition against a debtor only if he satisfies the following conditions:[1]

1. The debt owing by the debtor to the creditor, or if two or more creditors join in the petition, the aggregate amount of debts owing to such creditors, must amount of Rs 500 or more.

The debt must be in existence at the time of the alleged act of insolvency and also at the time of the presentation of the petition; it must continue to exist throughout the hearing of the petition and down to the order of adjudication *(Bhasker & Co.* vs. *Veerasikku*[2]*)*.

2. The debt must be a liquidated sum payable either immediately or at some future time.

Liquidated sum means a 'certain and ascertained sum admittedly due' without any *bonafide* and reasonable dispute with regard to it. If there is a *bonafide* dispute as to liability, the claim cannot form the basis of an insolvency petition, for it is not a claim for a liquidated sum *(Ratnaswami* vs *Subha Rediar*[3]*)*. Similarly, a claim for profits of a dissolved partnership, or for damages arising out of breach of contract, is not a liquidated sum and therefore cannot be made basis of an insolvency petition.

3. The act of insolvency on which the petition is based must have occurred within three months before the presentation of the petition.

4. The creditor or creditors must be unsecured creditors. A secured creditor cannot present an insolvency petition unless he places himself in the position of an unsecured creditor. Thus, if the petitioning creditor is a secured creditor, he must in his petition *either* state that he is willing to relinquish his security for the benefit of his fellow creditors in the event of the debtor being adjudged insolvent, *or* give an estimate of the value of the security in his possession and assert that the value of the security is insufficient to meet his claim and the amount of deficiency is Rs 500 or more.

All the above stated conditions must be fulfilled before a creditor can present a valid petition for the adjudication of a debtor as insolvent. Moreover, the petition must be duly supported by an *'affidavit'* of the creditor and the proofs of debts and debtor's act of insolvency.

Conditions for a Debtor's Petition

A debtor shall be entitled to present an insolvency petition only if he satisfies the following conditions[4].

[1]Section 12 of the Pres. T. Ins. Act and Sec. 9 of the Prov. Ins. Act.
[2]A.I.R. (1958), Mad. 379.
[3](1943), 2 Mad. L.J. 361.
[4]Sec. 14 of the Pres. T. Ins. Act and Sec. 10 of the Prov. Ins. Act.

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1. He must be 'unable to pay his debts"; *and*

2. *(a)* His debts must amount of Rs 500 or more; or *(b)* he must be under arrest or imprisonment in execution of a money decree; or *(c)* an order of attachment in execution of a money decree must have been made and must be subsisting against his property.

The expression 'unable to pay his debts' means that the total debts of the debtor exceed the marketable value of his assets if realised at that time. Also, a debtor is deemed to be "unable to pay his debts" if he has no liquid (presently realisable) assets wherewith to pay his debts at present, although he may be having more than sufficient assets to discharge his debts *(Pratapmal* vs *Chunilal*[5]*)*. When the inability to pay his debts is caused not due to inadequacy of assets but due to the fact that the assets cannot readily be turned into cash, the debtor is said to be 'commercially insolvent'.

The debtor's petition must also be duly supported by his 'affidavit' and other necessary proofs.

The following points must also be noted in connection with a creditor's petition or a debtor's petition:

1. An insolvency petition, whether presented by a debtor or by a creditor cannot be withdrawn without the leave of the court.

2. Where two or more insolvency petitions are presented against the same debtor, or where separate petitions are presented against joint debtors, the court may consolidate the proceedings on such terms as it thinks fit.

3. If a debtor by or against whom an insolvency petition has been presented dies, the proceedings in the matter shall, unless the Court otherwise orders, be continued so far as may be necessary for the realisation and distribution of the property of the debtor.

Admission and Hearing of the Petition

An Insolvency Petition is treated just like an ordinary plaint in a civil suit for the purpose of admission and as such the procedure laid down in the Code of Civil Procedure, 1908, with regard to admission of plaints, is followed while admitting an insolvency petition. Ordinarily, the petition shall be admitted by the Court, if, after the scrutiny of the petition, it is satisfied that there is no formal defect, that is, the conditions for a 'creditor's petition' or a 'debtor's petition' as prescribed by the Acts (discussed above) are duly complied with by the applicant and proper affidavit and other supporting proofs have been attached thereto.

After an Insolvency Petition is admitted, the Court shall make an order fixing the date for hearing the petition. Notice of the order should be given in the prescribed manner and must also be served on the other party.

[5] I.L.R. 60 Cal. 345.

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Specific notice to individual creditors can be given only where the names and addresses of the individual creditors are known from any part of the petition *(Punjab National Bank Ltd.* vs *Jethamal*[6]*)*.

On the day fixed for the hearing of the petition, the court will require proof of the necessary facts mentioned in the petition. In the course of hearing, the Court shall also examine in debtor, if he is present, as to his conduct, dealings and property, in the presence of such creditors as appear at the hearing, and the creditors have the right to question the debtor thereon. This is called 'Public Examination' of the debtor. Under the Presidency Towns Insolvency Act, this Examination of the debtor is held after the Order of Adjudication but before the Order of Discharge. The Court must, if sufficient cause is shown, grant time to the debtor or any creditor to produce any evidence which appears to it to be necessary for the proper disposal of the petition.

If all the necessary facts are proved, the Court will issue the Order of Adjudication, otherwise it will dismiss the petition. The Court shall dismiss a debtor's petition if it is not satisfied of his right to present the petition. The Court shall dismiss the petition of a creditor:

(a) if it is not satisfied with the proof of *(i)* the debt of the petitioning creditor, or *(ii)* the alleged act of insolvency, or

(b) if it is satisfied by the debtor that he is able to pay his debts or that for any other sufficient cause no order ought to be made, *e.g.,* he has not been served with the notice of the order admitting the petition.

While dismissing a creditor's petition, if the court is satisfied that the petition was frivolous vexatious, the court may, on the application of the debtor, award against such creditor a sum not exceeding Rs 1,000 towards compensation to the debtor for the expense or injury occasioned to him by the petition and the proceedings thereon.

Duties of the Debtor on Admission of the Petition

On the making of an order by the Court admitting the Insolvency Petition and before the passing of the Order of Adjudication, the debtor must:

(i) produce all books of account;

(ii) furnish details regarding his property, creditors and debtors; .

(iii) at any time, thereafter, submit to such examination in respect or his property or creditors, as may be required by the Court;

(iv) attend before the Court or Interim Receiver as and when required; and

[6](1958), Raj 223 (D.B.).

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(v) execute such instruments and do such things in relation to his property as may be required by the Court or Interim Receiver.

If the debtor wilfully fails to perform the above mentioned duties, he shall be punishable on conviction with imprisonment which may extend to one year.

INTERIM PROCEEDINGS BEFORE ADJUDICATION

Appointment of Interim Receiver

Interim Receiver means an official appointed by the Court to take possession of the property of the debtor with a view to preserving the same between the time of the admission of the insolvency petition and the making of an order of adjudication. The Official Assignee or Receiver may be appointed Interim Receiver.

Under Section 16 of the Presidency Towns Insolvency Act, the Interim Receiver *may* be appointed by the Court, if it is satisfied that such an appointment is necessary for the protection of the estate of the debtor or any part thereof. Thus, it is a discretionary power of the Court under the Presidency Act. Under Section 20 of the Provincial Insolvency Act, the Court *may,* and where the debtor himself is the petitioner ordinarily *must,* appoint an Interim Receiver of the property of the debtor or any part thereof. Thus, under the Provincial Act, the Court is bound to appoint an Interim Receiver on the admission of a 'debtor's petition' but enjoys a discretion on a 'creditor's petition'. The appointment may, however, be made either at the time of making an order admitting the petition or at any subsequent time before adjudication.

The Interim Receiver will take immediate possession of the property of the debtor and shall exercise such powers as conferred by the Court. Whatever may be the powers conferred upon an Interim Receiver, the property of the debtor does not vest in him as it does in an Official Assignee or Receiver appointed after adjudication. In other words, the appointment of an Interim Receiver has not the effect of divesting a debtor of his property but merely protects it and the debtor continues to be the legal owner of the property. The Official Assignee or Receiver is appointed after the adjudication for the purpose of realisation of the assets of the insolvent and distribution of the proceeds thereof among his creditors, whereas an Interim Receiver is appointed to safeguard the interests of creditors; *e.g.,* to check preferential or fraudulent dealings by the debtor or to check harassment of the debtor by some creditor (certain creditor may attempt to take away the property of debtor by force); in case the main petition were to result in an adjudication of the debtor.

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Interim Orders against Debtor

Section 21 of the Provincial Insolvency Act makes provision for interim orders against the debtor. Accordingly, at the time of making an order admitting the petition or at any subsequent time before adjudication, the Court may, either of its own motion or on the application of any creditor, make *one or more* of the following orders namely:

(i) order the debtor to give reasonable security for his appearance until final orders are made upon the petition and direct that, in default of giving such security, he shall be detained in the civil prison; or/and

(ii) order the attachment by actual seizure of the whole or any part of the debtor's property; or/and

(iii) order to issue warrant with or without bail for the arrest of the debtor, until the disposal of the petition.

But an order under clause *(ii)* or clause *(iii)* above shall be made only when the Court is satisfied that the debtor, with intent to defeat or delay the creditors or to avoid any process of the court:

(a) has absconded or is about to abscond from the local limits of the jurisdiction of the court; or

(b) has failed to disclose or has destroyed, or is about to destroy, any documents likely to be of use to his creditors in the course of the hearing of the petition.

Section 23 of the Provincial Insolvency Act further empowers the Court to order, at any time after admitting the petition but before adjudication, the release of the debtor, where he is under arrest in execution of a money decree, on such terms as to security as may be reasonable. The Court may also order the re-arrest of a person so released.

There are no provisions similar to that of Sections 22 and 23 (discussed above) in the Presidency Towns Insolvency Act.

ORDER OF ADJUDICATION

An 'order of adjudication' is an order of the Court declaring or adjudging a debtor an insolvent (*i.e.*, unable to pay his debts). If the facts alleged in the Insolvency Petition are proved and Court does not dismiss the petition it shall make an 'order of adjudication.' The Court may make an order of adjudication, even in those cases, where 'on a hearing adjourned for the purpose of serving the petition on the debtor, the debtor does not appear and service of the petition on him is proved.'[7] The court, while making an order of adjudication, shall also specify in such order the period within which the insolvent debtor should apply for his discharge.

7 *cf.* Mulla on the *Law of Insolvency in India*, 3rd Edn. (1977), p. 134.

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Notice of an order of adjudication stating the name, address and description of the insolvent, the date of the presentation of the petition, the date of adjudication, the period within which the insolvent debtor shall apply for his discharge, and the court by which the adjudication is made, shall be published in the Official Gazette and in such other manner as may be prescribed (Secs. 20 and 30 of the Pres. T.I. Act and the Prov. I. Act respectively).

Effects of an Order of Adjudication

On the making of an order of adjudication, the proceedings in insolvency assume a new phase. Thenceforth all proceedings come under the control of the Insolvency Court as represented by the Official Assignee or Receiver, as the case may be, and it becomes an important duty of the insolvent debtor to assist the Court or the Official Assignee or Receiver to the utmost of his power in the realisation of his property and the distribution of the proceeds among his creditors. The effects of this Order are as follows:

1. **Vesting of insolvent's property in Official Assignee or Receiver.** The properties of the insolvent (except properties held by him in Trust for others or in a fiduciary capacity, amount standing to the credit of insolvent in Provident Fund, and tools of trade, wearing apparel, utensils and similar other items) vest in an officer of the court who is called the Official Assignee (under the Pres. T.I. Act) or the Official Receiver (under the Prov. I. Act). The tools of trade, wearing apparel, *etc.*, exempted from vesting in the Official Assignee should not exceed in all Rs 300 in value under the Presidency Act. Under the Provincial Act, in addition to the items described above, agricultural buildings *etc.*, are also exempted from vesting in the Official Receiver and hence there is no such limit as to value.

All the properties of the insolvent *in India*, whether movable or immovable, (except the items mentioned above) automatically vest in the Official Assignee and become divisible among the creditors.[8] As regards properties of the insolvent *outside India,* it has been held that movable properties vest in the Official Assignee or Receiver but immovable property will not so vest, unless the foreign law permits it (*Yokohama Specie Bank* vs *Curlenders & Co.*[9]).

As a consequence of the vesting of property in the Official Assignee or Receiver, the insolvent no longer possesses any power to deal with such property in any way and every transaction by the insolvent shall be void as

[8] For details as to what properties vest in the Official Assignee or Receiver and are divisible amongst the creditors, see next Chapter.

[9] 43 Cal. L. J. 436.

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against the Assignee or Receiver. Now it is only the Assignee or the Receiver who can validly deal with respect to the property and give title to a purchaser, file a suit to recover part thereof from a third person or prosecute a suit filed by the insolvent before adjudication.

2. **Personal disqualifications.** The insolvent is disqualified from: *(a)* being appointed or acting as a Magistrate; (b) being elected to any office of a local authority; *(c)* being elected as a member of local authority. These disqualifications are, however, removed *(a)* if the order of adjudication is annulled; or *(b)* if he obtains from the court an order of discharge, whether absolute or conditional, with a certificate that his insolvency was caused by misfortune without any misconduct on his part.

3. **No fresh suits by creditors in certain cases.** After the order of adjudication and during the pendency of the insolvency proceedings, the insolvent's creditors cannot commence any suit or other legal proceedings against the insolvent except with the prior permission of the court. The unsecured creditors have been provided with an alternate remedy in that they can prove their claims in insolvency before the Official Assignee or the Court (under the Prov. Ins. Act) and get a pro-rata dividend. No permission of the Court for instituting fresh suits against the insolvent is, however, necessary in the following cases:

(a) where a secured creditor files a suit to realise his security, but the Assignee or Receiver must also be a party to the suit in such a case;

(b) where the debt in question is 'not provable in insolvency,'[10] *e.g.*, in the case of a debt contracted by the insolvent after adjudication, *or* in the case of a claim for unliquidated damages arising otherwise than by reason of breach of a contract or breach of trust, *e.g.*, claim for damages for torts (none of these constitute a 'debt provable in insolvency');

(*c*) to file a criminal suit for an offence alleged to have been committed by the insolvent.

In the above mentioned cases suits can be filed against an adjudicated insolvent during the pendency of the insolvency proceedings. But no suits can be filed for debts which are 'provable in insolvency' unless leave of the court is obtained before the institution of the suit.

4. **Stay of pending suits.** Any court in which a suit is pending against the debtor in respect of any debt 'provable in insolvency' shall on proof that an order of adjudication has been made against him, either stay the proceeding, or allow it to continue on such terms as the court may impose.

5. **Relation back.** The order of adjudiction/will relate back to, and take effect from, the commencement of insolvency. (For details see the next side-heading: 'Doctrine of Relation Back.')

[10] For details of '*Debts not Provable in Insolvency*,' see next Chapter

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6. **Protection order.** The court may, after passing an order of adjudication, also grant a 'protection order' to the insolvent on his application, prohibiting the arrest or detention of the insolvent debtor in execution of a decree for the payment of money, and, if already arrested, order his release. The protection order may be granted with regard to all debts or some of them and may commence at and take effect for such time as the court may direct. The Court may also at any time renew or revoke the same.

The object of making a 'protection order' is to protect an honest insolvent debtor from the harassment of his creditors after he has officially declared his inability to pay his debts in full. This Order is an example of the infusion of humanity into the law.

7. **Appointment of a manager.** The Court may, at the time of making an order of adjudication, appoint a special manager, for such period and on such terms as it may consider to be reasonable, to assist the Official Assignee, if in its opinion it is necessary from the point of view of debtor's business or the interest of the creditors in general (Sec. 19 of the Pres. T. Ins. Act). There is no such specific provision in the Provincial Insolvency Act, but the Court may follow it there also.

8. **As regards period of limitation.** If a debt is not already time barred at the time of adjudication order, time will not run, so far as the Limitation Act goes, during the period of insolvency, *i.e,* from the date of adjudication till the date of the order of discharge. In case of annulment of an order of adjudication, time will again run for computing the period of limitation from the date of annulment.

Doctrine of Relation Back

Both the Insolvency Acts provide that the order of adjudication shall relate back to, and take effect from, a date earlier than the date of making such an order. Based on this provision, the "doctrine of relation back" lays down that the 'insolvency of a debtor commences not from the date of the Adjudication Order, but it shall be deemed to commence at an anterior date'. The anterior date at which the insolvency of a debtor shall be deemed to commence is referred to as the date of "commencement of insolvency."

The dates of 'commencement of insolvency' differ under the two Acts.

Under Section 28(7) of the Provincial Insolvency Act, the insolvency of a debtor commences from (*i.e.*, the order of adjudication relates back to) the date of the presentation of the insolvency petition on which the order of adjudication is made.

Under Section 51 of the Presidency Towns Insolvency Act, the insolvency of a debtor commences from (*i.e.,* the order of adjudication relates back to) the date of the first available act of insolvency committed within

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three months before the presentation of the insolvency petition.

It will thus be seen that under the Presidency Towns Insolvency Act insolvency commences at a much earlier date.

The date of 'commencement of insolvency' is important for various matters such as avoidance of 'objectionable voluntary transfers' and 'fraudulent preferences' which might have been made by the insolvent debtor on the eve of insolvency with a view to defrauding his creditors. As a result of the 'doctrine of relation back' the title of the Official Assignee or Receiver with respect to the insolvent's property is not limited to the date of the adjudication order, but is made to relate back to the date of 'commencement of insolvency'. As such all *objectionable transactions* entered into by the insolvent in respect of his property between the commencement of insolvency and the date of the order of adjudication will not be binding on the Official Assignee or Receiver and he can recover back all such property. Note that *bonafide* purchases for value will get good title unless the transaction amounts to transfer by way of 'fraudulent preference' in favour of one of the creditors.

Effect of Insolvency on Antecedent Transactions

The transactions which are entered into by the insolvency in respect to his property prior to the 'commencement of insolvency' are known as 'antecedent transactions'. It may be recalled that for all practical purposes, insolvency commences not from the date of adjudication but from an earlier date as discussed above under the "doctrine of relation back". The effect of insolvency on antecedent transactions may be seen under the following heads:

1. **Execution of decrees.** Where the order for the execution of a decree has been issued against the property of the debtor before the commencement of insolvency, no sale of property attached in execution shall be allowed against the Official Assignee/Receiver, and the execution creditor can only claim a rateable dividend from the insolvent's estate. Of course, assets already sold in the course of the execution before the date of admission of the insolvency petition cannot be taken away by the Assignee or Receiver, provided both the execution creditor and the purchaser of property acted *bonafide i.e.*, without notice of the presentation of the insolvency petition. If only the purchaser of property under a sale in execution acted *bonafide*, then he gets a good title as against the Assignee or Receiver but the execution creditor will have to account for the money so received by him to the Assignee or Receiver.

However, the adjudiction does not affect the rights of the secured creditors in respect of property against which the decree is executed.

2. **Avoidance of voluntary transfers.** All voluntary transfers of property by the debtor within two years immediately preceding the

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'commencement of insolvency' shall be void against the Official Assignee or Receiver, as the case may be. But the following two types of voluntary transfers are protected and shall not be void:

(*a*) Transfer to the wife of the insolvent made before and in consideration of marriage.

(*b*) Transfer made in favour of a purchaser or incumbrancer in good faith and for valuable consideration. In order to uphold a transfer under this clause, the transfer must not only be for valuable consideration, but must also have been made in good faith. Of course, the consideration should be illusory or nominal, along with bad faith, in order to make an avoidance meaningful.

It may be noted that in case of voluntary transfers amounting to "fraudulent transfer" *i.e.,* nominal transfer (*benami* transfer) in the name of a *sham holder,* the transfer shall be void as against Official Assignee or Receiver irrespective of time when such a transfer was made. No time limit is fixed here in the case for enabling an avoidance of the same.

3. **Avoidance of Fraudulent preferences.** A 'fraudulent preference' means a preference given deliberately to some of the creditors in matter of payment or transfer of property to the exclusion of other creditors, though the transfer may be for adequate consideration. It should be noted that a preference is fraudulent only when the *dominant idea* in the mind of the debtor was to prefer one creditor over others. The mere making of a preferential payment is not a fraudulent preference. The substantial motive of the debtor in making it must be looked at. If the substantial motive is not to prefer the creditor but to benefit himself, there is no fraudulent preference. Thus payment made by a debtor on the eve of his insolvency to a creditor under pressure or threat of legal proceedings, is not a fraudulent preference.

Every *fraudulent preference* is void as against the Official Assignee or Receiver, if the debtor is adjudged insolvent on a petition presented within three months of the date of transfer or payment, and the creditor so preferred must return the property, goods or money so obtained to the Assignee or Receiver. But if the creditor had already transferred any of the properties so obtained by him to a *bonafide* purchaser for value, the title of sub-buyer shall be good and the creditor would have to pay cash for that.

The provisions of law regarding avoidance of "voluntary transfers" and "fraudulent preferences" are of great significance, for if they were not there, a person in embarrassed circumstances, seeing that insolvency was impending, might easily defeat the aim of an equitable division of his property amongst his creditors.

4. **Protected transactions.** "Protected transactions" are those transactions in relation to the insolvent's property which are not invalidated by the

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insolvency proceedings. All *bonafide* (fair and honest) transactions (*e.g.*, payments to creditors, receipt of money or goods, transfer of property or goods) for *valuable consideration* entered into by the insolvent shall be valid and binding upon the Official Assignee or Receiver, provided that:

(i) the transaction has taken place before the order of adjudication,

(ii) the other party to the transaction acts *bonafide i.e.*, had no knowledge of the presentation of the insolvency petition by or against the debtor, and

(iii) the transaction is not an *objectionable voluntary transfer* or a transfer amounting to *fraudulent preference* or *fraudulent transfer (i.e.,* benami transfer).

Duties of the Insolvent after Adjudication

1. **To submit a schedule of his assets and liabilities.** Under Section 24 of the Presidency Towns Insolvency Act, where an order of adjudication is made against a debtor, he is required to prepare and submit to the Court, a schedule of his assets and liabilities verified by affidavit in prescribed form, within 30 days of the order of adjudication (if the order is passed on the petition of the debtor) and within 30 days of the service of the order of adjudication (if the order is passed on the petition of a creditor). If without any reasonable excuse the insolvent fails to submit a proper and correct schedule, he may be committed to the civil prison by the Court.

There is no such requirement under the Provincial Insolvency Act, where as per Section 33, the Court, through the Official Receiver, is required to prepare a *schedule of creditors* of the insolvent.

2. **To attend the meetings of his creditors.** The insolvent must, unless prevented by sickness or other sufficient cause, attend such meeting of his creditors as the Official Assignee or Receiver requires him to attend, and disclose before the meeting such information as may be required.

3. **To execute powers-of-attorney etc.** The insolvent must execute such powers-of-attorney, transfers and instruments[11] as may be required by the Official Assignee or Receiver, and must do all such acts and things in relation to his property as may be required by the Assignee or Receiver.

4. **To assist in realisation and distribution of property.** To insolvent must assist the Official Assignee or Receiver, to the utmost of his power, in the realisation of his property and the distribution of the proceeds amongst his creditors.

5. **To answer questions during his 'Public Examination'.** Under Section 27 of the Presidency Towns Insolvency Act, after an order of

[11]The execution of instruments like powers-of-attorney may be necessary in case of 'Patent Rights' or 'Copy Rights' or Life Insurance Policies, *etc.*, which are also included in the insolvent's property,

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adjudication has been made, the Court fixes the date for holding a *Public Examination* of the insolvent in order to determine the causes of insolvency. A notice of the Public Examination is given to all the creditors in the prescribed manner. The insolvent must, on the appointed date, attend Court and answer all questions put to him by the Court, the Official Assignee and any creditor. The notes of the Examination shall be taken down in writing and shall be read over either to or by the insolvent and signed by him, and may thereafter be used in evidence against him and shall be open to the inspection of any creditor at all reasonable times. The Court may dispense with such Examination if the insolvent is a lunatic, or a 'pardanashin lady' or if he or she is suffering from any mental or physical disability.

Under the Provincial Insolvency Act, there is no such provision for the Public Examination of the insolvent after the order of adjudication. Under that Act the Court must hold such an Examination before the order of adjudication is made *i.e.*, at the time of the hearing of the insolvency petition.

Penalty. If the insolvent wilfully fails to perform any of the duties imposed upon him or, fails to deliver up possession to the Official Assignee or Receiver of any part of his property which is divisible among his creditors, he shall, in addition to any other punishment to which he may be subject, be guilty of a contempt of Court and may be imprisoned upto one year.

Private Examination

The Court may, on the application of the Official Assignee *or* the Official Receiver *or* any creditor who has proved his debt, summon before it the insolvent *or* any other person who is known *or* suspected to have in his possession any property belonging to the insolvent *or* is supposed to be indebted to the insolvent *or* is capable of giving information regarding the insolvent's property or the causes of insolvency. The Court may, examine any person so brought before it concerning the insolvent, his dealings or property. Such an Examination is called the *Private Examination.*

If any person so summoned, after having being tendered a reasonable sum, refuses to come before the Court at the time appointed, or refuses to produce any documents in his custody without any lawful excuse, the Court may, by warrant, cause him to be apprehended and brought up for examination.

TEST QUESTIONS

1. Explain clearly the circumstances in which *(i)* a creditor, *(ii)* a debtor himself can present an insolvency petition. When can the Court dismiss a creditor's petition?

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2. Discuss the procedure of admitting and hearing of an insolvency petition. Also point out the duties of the debtor on admission of the petition.

3. What is an Order of Adjudication? What are its effects?

4. What is the effect of insolvency on antecedent transactions?

5. *(a)* Discuss the doctrine of Relation Back.

(b) Explain what is meant by Fraudulent Preference in Insolvency Law? What is the effect of such preference?

6. *(a)* Enumerate the duties of an insolvent after adjudication.

(b) Write a note on 'Private Examination'.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A* purchased certain goods on credit from *B*. On *A*'s wrongful refusal to pay for the goods on due date, *B* sued *A* for the recovery of the price thereof. A decree was passed in favour of *B*, but before the decree was satisfied *A* was adjudged insolvent. Examine the rights of *B*.

[Hint. No, sale of property in execution of the decree shall be allowed against the Official Assignee/Receiver, and *B* can only claim a rateable dividend from the estate of *A*.]

2. *P*, a creditor of *Q*, takes from *Q* a transfer of substantially the whole of *Q*'s property in satisfaction of his past debts. *P* knew that *Q* owed to other creditors. Six months thereafter an insolvency petition was admitted against *Q* and within next two months he is adjudged insolvent. Can the Official Receiver set aside the transfer in favour of *P* as a fraudulent preference?

[Hint. No, the transfer of property in favour of *P* cannot be set aside as a fraudulent preference. In the instant case an insolvency petition was admitted against *Q* six months after the date of transfer, whereas a fraudulent preference is void against the Official Receiver only if the debtor is adjudged insolvent on a petition presented within three months of the date of transfer.]

3. *X*, a businessman, makes a gift of house to his daughter *Y* in June 1992. In July 1993 he suffers heavy losses and commits an act of insolvency on which a petition is presented by a creditor in August, 1993. *X* is adjudicated insolvent in January 1994. Can the Official Assignee impeach *X*'s gift to his daughter?

[Hint. The Official Assignee can impeach *X*'s gift to his daughter because all voluntary transfers without consideration made within two years of the 'commencement of insolvency' are void against the Official Assignee.]

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Chapter 37

Property and Debts of Insolvent

According to Section 2*(e)* of the Presidency Towns Insolvency Act and Section 2*(d)* of the Provincial Insolvency Act, the expression 'property of the insolvent' includes any property over which or over the profits of which he has a *disposing power* which he may exercise for his own benefit. Thus, insolvent's property includes not only those properties of which he is the owner but also such properties over which he has a disposing power. For example, on the insolvency of a Hindu father, his properties shall include his son's undivided interest as well, for he enjoys a disposing power over his son's interest. Further the word 'property' includes not only material objects (*i.e.*, movable and immovable properties) but also actionable claims which may be turned into money (*e.g.*, copy rights, goodwill, life insurance policy).

For the purposes of both the Insolvency Acts, the property of the insolvent may be divided into two categories, namely, *(i)* property which is divisible amongst the creditors; and *(ii)* property which is not so divisible amongst the creditors. In both the Acts, the expression 'property of the insolvent' means such of the insolvent's property *as is divisible amongst his creditors,* and it is such divisible property only which vests in the Official Assignee or Receiver, on the insolvency of the person concerned.

Property Divisible amongst Creditors

It includes the following types of properties:

1. *Property of which the insolvent is the owner.* All such property as may belong to the insolvent at the commencement of insolvency (except trust property, tools of trade, wearing apparel *etc.*,[1] and immovable property situated outside India).

2. *After acquired property.* The property which is acquired by the insolvent (*e.g.*, personal earnings through business or profession[2]) or which

[1]For details see next side-heading.

[2]Personal earnings (through salary or otherwise) by the insolvent after the commencement of insolvency must be handed over to the Official Assignee or Receiver, except such portion of it as may be allowed to the insolvent for his maintenance.

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devolves upon him (*e.g.*, legacy or gift or under 'will',) after the commencement of insolvency and before the date of his 'discharge' is called the *after acquired property* of the insolvent. Under the Provincial Insolvency Act, property of this category vests *automatically* in the Official Receiver as from the date of the acquisition or devolution and the insolvent cannot validly deal with it in the absence of title. But under the Presidency Town Insolvency Act, *after acquired property* does not vest in the Official Assignee until he intervenes and claims the property *(Cochen* vs *Mitchell*[3]). Before his intervention and claiming the property, the insolvent can validly deal with such property and transfer a good title to any person who takes it in good faith and for value.

3. *Property over which the insolvent has a right of disposal.* Thus, on the insolvency of a Hindu father, his property shall include his son's undivided interest as well, for he enjoys a disposing power over his son's interest.

4. *Property of which the insolvent is the 'reputed owner'.* Goods of which a person is the 'reputed owner', also vest in the Official Assignee or Receiver on the insolvency of the person. (For details see: 'Doctrine of Reputed Ownership.')

Property Not Divisible amongst Creditors

The following types of properties of the insolvent are not available for distribution amongst the creditors and therefore do not pass to the Official Assignee or Receiver.

1. *Property held by the insolvent in trust or in a fiduciary capacity.* Thus, property in the hands of an insolvent in a fiduciary capacity, *e.g.*, as a broker, factor, auctioneer, bailee, trustee, or solicitor will belong to the principal or the beneficiary, and will not vest in the Official Assignee or Receiver.

2. *Tools of trade, wearing apparel, etc.* Under the Presidency Town Insolvency Act, the insolvent is entitled to retain his tools of trade (if any), necessary wearing apparel, bedding, cooking vessels, and furniture of himself, his wife and children, to a value not exceeding Rs 300 in all. The Provincial Insolvency Act, however, does not fix any such limit of specified amount. It contains a general provision that the insolvent is entitled to retain all such property (not being books of account) as is exempted by the Code of Civil Procedure, 1908, or any other enactment for the time being in force, from liability to attachment and sale in execution of a decree. This includes *(a)* necessary wearing apparel, cooking vessels, tools of trade, beddings, beds, such personal ornaments as, in accordance with the

[3](1880), Q.B.D. 262.

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religious usage, cannot be parted with by a woman (*e.g.*, Mangal Sutra); and *(b)* houses and other buildings belonging to an *agriculturist* and occupied by him as such for the purpose of agriculture, that is, necessary to enable him to cultivate the land. The term 'agriculturist' here means a person whose sole means of livelihood is gained by cultivating a small holding (*N. Reddiar* vs *Official Receiver*[4]).

3. *The right to sue a third party in respect of a tort* or personal injury.

4. *A 'spes successionis', i.e.,* a mere chance of getting some property upon the death of a near relative.

5. *Personal earnings of the insolvent* provided they are not more than such amount as may be necessary to maintain the insolvent and his family.

6. *Moneys in a 'recognised provident fund', gratuity* payable to a railway servant, *and pensions* payable to retired Government employees. It is to be noted that as soon as the amount of Provident Fund, or Gratuity, or Pension reaches the hands of an undischarged insolvent (depositor or employee), it is treated as 'after acquired property' of the insolvent, that is, it vests in the Official Receiver automatically, and the Official Assignee (under the Pres. T. Ins. Act) can intervene with respect to it (*i.e.,* can take active steps to assert his title thereto).

Doctrine of Reputed Ownership

The 'doctrine of reputed ownership' is based on the provisions of law as contained in Sections 52(2) (*c*), and 28(3) of the Presidency Towns Insolvency Act and the Provincial Insolvency Act respectively. These Sections provide that goods which are at the 'commencement of the insolvency' in the possession, order or disposition of the insolvent in his trade or business, by the consent and permission of the true owner, under such circumstances that he is the reputed owner thereof, shall be deemed to be the property of the insolvent and will be divisible among his creditors. Accordingly, the 'doctrine of reputed ownership' states that goods which are not really the property of the insolvent, but of which the insolvent is the apparent or reputed owner also come within the ambit of the estate of the insolvent and vest in the Official Assignee or Receiver, if certain conditions are satisfied. These conditions are:

1. The insolvent must be a *trader.*

2. The property must be *goods and movable property.*

3. The goods must be in the *sole possession, order or disposition* of the insolvent in *his trade or business* at the commencement of the insolvency. The goods need not necessarily be in the actual possession of the insolvent. They may be in the order or disposition of the insolvent, that is, in the

[4](1926) 49 Mad. 227.

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possession of his servant, or of a warehouse-keeper or carrier on his behalf, or of one who has hired them from the insolvent. Further, the goods must be acquired for the purpose of trade or business and used for those purposes. Goods acquired for personal use, *e.g.,* household furniture, shall not be taken to be the goods in trade.

4. The possession, order or disposition must be with the consent of the true owner, and not through fraud or mistake.

5. The true owner must consent not only to the possession of the goods by the insolvent but also to the *reputation of ownership.* In other words, the true owner must consent to the possession by the insolvent under such circumstances that persons dealing with him shall be entitled to assume that the insolvent is the owner of the goods.

6. There must be no mark or other indication showing that the goods belong to some person other than the insolvent.

All the above conditions must be complied with for the application of the doctrine of reputed ownership.

The doctrine usually applies to cases where the true owner has lent his goods for use to the insolvent, or let them out on hire to him, or sent them to his shop for sale, or having brought the goods from the insolvent has allowed the insolvent to continue in possession thereof, *etc.* When property vests in the Official Assignee or Receiver under the doctrine of reputed ownership, the true owner can always prove for its value in the insolvency as an unsecured creditor of the insolvent.

The *doctrine of reputed ownership* does not apply in the following cases:

(i) Immovable properties.

(ii) Goods taken under hire-purchase agreement.

(iii) Goods in the possession of the insolvent as a trustee, bailee, repairer, carrier, factor, agent or pawnee.

It may be noted that the doctrine does not affect the rights of a secured creditor in any way. The doctrine has for its object the protection of the general creditors of a trader against the false credit which might be acquired by the trader on the basis of the goods in his possession and which appear to be his property, but in fact do not belong to him.

Disclaimer of Onerous Property

Sections 62 to 67 of the Presidency Towns Insolvency Act contain provisions relating to disclaimer of onerous property. The Provincial Insolvency Act contains no such provisions and cases falling under this category are settled under the general law.

'Onerous property' implies a property which in effect has ceased to be an asset and has become a liability, *for example,* unsaleable property *or*

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unprofitable contracts *or* the land burdened with onerous convenants *or* partly paid up shares of an unsuccessful company (the market value of which is less than the amount of calls due on them).

Section 62 of the Presidency Towns Insolvency Act confers a power on the Official Assignee to disclaim (*i.e.,* refuse to accept) any onerous property belonging to the insolvent with a view to preventing the Official Assignee from being burdened with the obligations connected with such property. The power to disclaim onerous property is an exception to the general rule that the Official Assignee takes the insolvent's property subject to all equities.

For a valid disclaimer of onerous property, it must be made by notice in writing signed by the Official Assignee within 12 months of the date of the order of adjudication or within 12 months of the date on which the Official Assignee came to know of the existence of such property. The Official Assignee is not entitled to disclaim any leasehold property without the leave of the Court.

The disclaimer releases the Official Assignee from liability in respect of the property disclaimed but it does not affect the rights or liabilities of any other person in respect of that property. Any person injured by the operation of a disclaimer may apply the Court for the award of damages for the non-performance of the contract, and if the Court passes an order awarding damages payable to any such person, the amount of damages may be proved by him as a debt under the insolvency.

It may be noted that the Official Assignee may disclaim any onerous and burdensome property irrespective of the fact that he has taken possession of the property or exercised any act of ownership in relation thereto. But he shall not be allowed to disclaim any property where an application in writing has been made to him by any person interested in the property, requiring him to decide whether he will or will not disclaim the property concerned, and the Official Assignee has not, within 28 days after receipt of the application or such extended period as the Court may allow, given notice to the applicant that he disclaims the same. In the case of a contract, the Official Assignee shall, on failure to give such notice, be deemed to have adopted the same.

Official Assignee and Official Receiver

The official appointed to help the Court to complete the insolvency proceedings, *i.e.,* to realise the assets of the insolvent and distribute the same amongst the creditors most fairly, is called the *Official Assignee* under the Presidency Towns Insolvency Act, and the *Official Receiver* under the Provincial Insolvency Act. He is a corporation sole and as such has a perpetual succession and an official seal. He may sue and be sued in his

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corporate name, *e.g.*, "The Official Assignee of Mr..... insolvent," and may do all acts necessary or expedient to be done in the execution of his office.

Official Assignee. The Official Assignee of Madras presidency town is appointed by the Chief Justice of the High Court at Madras. In the case of Calcutta presidency town, he is appointed by the State Government of West Bengal, after consultation with and with the concurrence of, the Chief Justice of the High Court at Calcutta. For Bombay presidency town, he is appointed by the State Government of Maharashtra.

Every Official Assignee may be called upon to furnish such security and is subject to such rules and is required to act in such manner as may be prescribed. He is to be paid such remuneration as may be prescribed by Rules and no more—in the nature of a commission or percentage on the amount realized by him or distributed by him amongst the unsecured creditors.

Official Receiver. The State Government may appoint such persons as it may think fit to be Official Receivers under the Provincial Act, to act within such local limits as may be prescribed. Where such an Official Receiver has been appointed for any local limits, he shall be the *receiver* for the purpose of every order appointing a *receiver* or *interim receiver* made by the Court exercising jurisdiction within those limits, unless the Court for special reasons otherwise directs.

The Court may, at the time of the order of adjudication, or at any time afterwards, appoint a receiver for the property of the insolvent. The Court may require the Receiver to give such security as it thinks fit for duly accounting for the insolvent's property which he receives. It shall also fix his remuneration to be paid out of the assets of the insolvent. Where no Receiver is appointed, the Court shall have all rights of, and may exercise all the powers conferred on, a Receiver under this Act.

Powers of the Official Assignee and Receiver. Certain powers are conferred upon the Official Assignee/Receiver under both the Acts. He can exercise some of these powers on his own account *without the permission of the court,* and can exercise some of them *with the permission of the court.*

Powers without the permission of the court. The Official Assignee or the Receiver can exercise the following powers without obtaining any prior approval of the Court:

1. To sell all or any part of the property of the insolvent.
2. To give receipts for any money received by him.
3. To distribute the sale proceeds as 'dividend', from time to time among the creditors proportionately. Of course, under the Presidency Towns Insolvency Act, sanction of the court is needed for declaring and paying the 'final dividend'.

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Powers with the permission of the court. The Official Assignee or the Receiver can also exercise the following powers with the permission of the Court:

1. To carry on the business of the insolvent, so far as may be necessary, for the beneficial winding up of the same.

2. To institute, defend or continue any suit or other legal proceeding relating to the property of the insolvent.

3. To employ a pleader or other agent to take any proceedings or do any business which may be sanctioned by the court.

4. To accept as the consideration for the sale of any property of the insolvent, moneys payable at a future date *(e.g.,* Bills of Exchange or Promissory Notes) or fully paid-up shares or debentures on such terms as to security as the court thinks fit.

5. To mortgage or pledge any part of the property of the insolvent for the purpose of raising money for the payment of his debts or for the purpose of carrying on the business.

6. To refer any dispute to arbitration, and compromise all debts, claims and liabilities, on such terms as may be agreed upon.

7. To divide in its existing form amongst the creditors, according to its estimated value any property which, from its peculiar nature or other special circumstances, cannot readily or advantageously be sold.

It should be noted that the exercise of all the above powers is subject to the control of the Court. To check the Official Assignee or Receiver from abusing his powers, both the Acts provide that any person aggrieved by any act or decision of the Official Assignee or Receiver, as the case may be, may apply to the Court within 21 days from the date of the act or decision complained of, and the Court may confirm, reverse or modify the act or decision complained of, and make such further order as it thinks just.

Duties of the Official Assignee or Receiver. The following are the most important duties of an Official Assignee or Receiver:

1. He must take into custody and control all the books, documents and the assets of the insolvent.

2. He must realise the property of the insolvent with all convenient speed in most profitable manner.

3. He must act and function in an honest and impartial manner while distributing the moneys received by him amongst the creditors because he stands in a fiduciary relationship towards them.

4. He must maintain proper books and submit his accounts to the Court at such periods and in such form as the Court directs.

5. He must, from time to time, summon meetings of the creditors and pay due regard to the wishes of the creditors as indicated in such meetings,

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and must submit "schemes of arrangement and composition,"[5] if any, before the creditors.

6. He must do all such acts as may be required by the Court from time to time, for example, he may be asked to investigate the conduct of the insolvent and make a report to the Court which may guide the Court in making an 'order of discharge'.

Superior title of the Official Assignee or Receiver. We have observed earlier that on the making of an order of adjudication, the property of the insolvent vests in the Official Assignee or Receiver, as a result of which the insolvent no longer possesses any power to deal with such property and it is only the Assignee or Receiver who can validly deal with respect to the property. This provision makes us to believe that the Official Assignee or Receiver completely takes the place of the insolvent after his adjudication. A close study of the legal provisions relating to the powers of the Official Assignee or Receiver further reveals that he enjoys *wider powers* and has a *superior title* than the insolvent in matters arising out of insolvency. To substantiate this assertion the following provisions of the two Insolvency Acts may be cited:

1. *Doctrine of reputed ownership.* We have seen that under the "doctrine of reputed ownership", goods which are not really the property of the insolvent, but of which the insolvent is the apparent or reputed owner also vest in the Official Assignee or Receiver provided certain conditions are satisfied. Thus, the Official Assignee or Receiver has a superior title to those goods of which the insolvent is only an apparent or reputed owner (and not the real owner), because he can deal with such goods as owner whereas the insolvent could not have dealt as such.

2. *Avoidance of voluntary transfers.* All objectionable transfers of property without consideration made by the insolvent within two years preceding the 'commencement of insolvency' are void against the Assignee or Receiver and he can recover the property so transferred. This again proves his superior title to that of the insolvent because he can set aside the title of the transferees without consideration which could not have been challenged by the insolvent himself.

3. *Avoidance of fraudulent preference.* The Official Assignee or Receiver has also a right to set aside every "fraudulent preference' (*i.e.*, transfer of property with a view to prefer one creditor over others) made by the insolvent within three months preceding the presentation of insolvency petition. It is also a proof of his superior title.

[5] *'Schemes of arrangement'* and *'Composition'* will be discussed later in detail in the present Chapter.

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4. *Disclaimer of onerous property.* Under the Presidency Towns Insolvency Act, and Official Assignee can disclaim onerous property, but the insolvent could not disclaim it.

In view of the above stated provisions, the saying that "in claims arising out of insolvency, the title of the Official Assignee or Receiver is superior to that of the insolvent" is perfectly justified.

Committee of Inspection

Both the Insolvency Acts provide that the Court may, if it so thinks fit, authorise the creditors who have proved their debts to appoint from among themselves a 'committee of inspection' for the purpose of superintending the administration of the insolvent's property by the Official Assignee or Receiver. The Committee shall have such powers of control over the proceedings of the Official Assignee or Receiver as may be prescribed.

Composition and Scheme of Arrangement

A debtor cannot settle with his creditors out of Court regarding the payment of the debts after the insolvency proceedings commence. That can be done only by a 'Composition' or 'Scheme of Arrangement' as provided by the two Insolvency Acts.

A 'Composition' is an agreement between the insolvent debtor and all or some of the creditors by which the creditors agree to abandon a part of their claims and accept payment of less than the amount due to them in full satisfaction of their claims. A 'Scheme of Arrangement' is an agreement between the insolvent debtor and his creditors by which the creditors agree for the gradual realisation of the amount due to them in due course of time, without selling all the debtor's assets.

Procedure. The procedure for *Composition* or *Scheme of Arrangement,* under both the Insolvency Acts, is as follows:

1. An adjudicated insolvent should submit a proposal for a *composition* in satisfaction of his debts, *or* a *scheme of arrangement* of his affairs in the prescribed form to the Official Assignee or Receiver.

2. Thereupon the Official Assignee or Receiver shall convene a meeting of creditors and refer the Scheme or Composition to the meeting.

3. If, on the consideration of the proposal in such creditors' meeting, a majority in number and three-fourth in value of all the creditors whose debts are proved and who are present either in person or by pleader, resolve to accept the proposal, it is put up before the Court for approval.

4. Whereupon the Court will fix a date for the consideration of the proposal, and shall issue a notice to all creditors and the Official Assignee or Receiver to attend the meeting at the date so fixed.

5. If, after hearing the Official Assignee or Receiver and the creditors

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and after considering the conduct of the insolvent and the objections of the dissentient creditors, if any, the Court is of the opinion that the proposal is reasonable and beneficial to the general body of creditors and provides reasonable security for payment of not less than 37 Paise in a rupee on all the unsecured debts in case of the Provincial Insolvency Act and 25 Paise in a rupee in case of the Presidency Towns Insolvency Act, it will give its sanction and then the proposal becomes binding on all the creditors.

6. After the Court approves the 'Scheme' or 'Composition', its terms shall be embodied in an order of the Court, and the order of adjudication shall be annulled. As a result the insolvency proceedings shall be terminated and the debtor will have the power to deal with his property in order to enable himself to pay the 'Scheme' or 'Composition'.

Annulment of 'composition' or 'scheme' and power to re-adjudge debtor insolvent. An approved 'Scheme' or 'Composition' may be annulled and the debtor may be re-adjudged insolvent if:

(i) the debtor commits default in the payment of any instalment due in pursuance of the *composition* or *scheme;* or

(ii) it appears to the Court that the *composition* or *scheme* cannot proceed without injustice or undue delay; or

(iii) the approval of the Court was obtained by fraud.

When a debtor is re-adjudged insolvent, all his property shall revest in the Official Assignee or Receiver but without prejudice to the validity of any transfer or payment duly made under or in pursuance of the *composition* or *scheme.* Further, all debts provable in other respects which have been contracted before the date of such re-adjudication shall be provable in the insolvency. It may be mentioned that the creditors can prove for their original debts and not simply what would have been due under the *composition* or *scheme.*

DEBTS OF INSOLVENT

We have stated earlier that on making an order of adjudication the insolvent's property vests in the Official Assignee or Receiver and the insolvent's creditors can no longer commence any suit against the insolvent. The creditors are required to prove their claims in insolvency before the Official Assignee (under the Presidency Towns Insolvency Act) or the Court (under the Provincial Insolvency Act) and get a *pro-rata* dividend out of the insolvent's property. In order to prove a debt, every creditor is required to deliver or send by post in a registered letter an *affidavit* containing particulars of the debt. The Official Assignee or the Court, as the case may be, may at any time call for the production of vouchers or other evidence in support of the claim.

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Debts Provable in Insolvency

Debts which can be proved and claimed in insolvency proceedings include:

1. All debts and liabilities, present or future, certain or contingent to which the debtor is subject when adjudicated insolvent.

2. All debts and liabilities to which the debtor may become subject before his discharge by reason of any obligation incurred before the date of adjudication.

Thus, practically all kinds of debts and liabilities of the insolvent debtor can be proved in insolvency, with certain exceptions,[6] provided the following conditions are satisfied:

(a) The debt or liability must have been incurred before the date of adjudication, though it may have become actual liability thereafter (of course before discharge). For example, Call made on party paid shares, or liability arisen on account of suretyship can be proved in insolvency.

(b) The debt or liability must be alive *i.e.,* must not be time-barred at the commencement of insolvency and must not be illegal or immoral.

(c) The debt or liability must be indisputable and ascertained, or must be capable of fair estimation. For example, damages for breach of contract may be ascertained by suing the Official Assignee or Receiver after adjudication and can be proved in insolvency.

In this connection, the following two points may also be noted:

1. As stated above, a debt payable in future is a provable debt and may be proved as if it were payable presently but the claimant will be entitled to share in the dividends with other creditors after deducting from the amount of the claim, the amount of interest at the rate of six per cent per annum computed from the date of declaration of the dividend to the time when the debt would have become payable under the contract.

2. Where there have been mutual dealings between an insolvent and a creditor proving or claiming to prove a debt, an account shall be taken of what is due from one party to the other in respect of such mutual dealings, and the sum due from one party shall be set off against any sum due from the other party, and the balance of the account, and no more, shall be claimed or paid on either side respectively.

Interest on provable debts. Section 48 of the Provincial Insolvency Act and Rule 23 of Schedule II of the Presidency Towns Insolvency Act provide the following rules as to interest on provable debts:

(i) Where interest is agreed upon, interest not exceeding 6 per cent per annum can be proved by the creditor only upto the date of the order of adjudication without prejudice to his right of receiving the agreed higher

[6]For these exceptions refer to the next heading *'Debts not Provable in Insolvency'*.

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rate after all the debts proved have been paid in full.

(ii) Where no interest is agreed upon but there is a due date, interest no exceeding 6 per cent per annum may be proved from the due date to the date of adjudication.

(iii) Where neither interest is agreed upon nor there is a due date, interest not exceeding 6 per cent per annum may be proved from the date of the 'demand notice' to the date of adjudication, provided the debtor has been informed through the said notice that the interest will be claimed from the date of the demand until the time of payment.

Debts not Provable in Insolvency

The following debts are not provable in insolvency;

1. Contingent debts and liabilities, the value of which cannot be fairly estimated.

2. Demands in the nature of unliquidated damages arising otherwise than by reason of breach of a contract or breach of trust. Thus, claims for damages for torts or in respect of frauds otherwise than in business cannot br proved.

3. Time-barred debts at the commencement of insolvency.

4. Debts contracted after the order of adjudication.

5. Under the Presidency Towns Insolvency Act, debts contracted (although before adjudication) from a person who had knowledge of the presentation of the insolvency petition, cannot also be proved.

Right of Secured Creditor to Prove his Debt

A secured creditor need not prove his debt in the insolvency of the debtor. He can, independently of the insolvency Court, realise his security with a view to satisfying his claim. But where the security is not sufficient to meet his claim, he may come to the insolvency proceedings. In such a case three courses are open to him:

1. He may realise his security and then prove for the balance of his claim that may still remain due to him; or

2. He may surrender his security for the general benefit of the creditors and prove for the whole debt that may be due to him as an unsecured creditor; or

3. He may value his security and state the assessed value in his proof and then prove for the balance that may remain due to him after deducting the assessed value subject to the right of the Court to redeem the security on payment to the creditor of the assessed value.

Where a secured creditor does not comply with any of the above provisions, he shall be excluded from all shares in any dividend, and in that case, he shall have to content with his security.

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Rules Regarding the Distribution of Insolvent's Property

Upon adjudication of a debtor as insolvent, the Official Assignee or Receiver must, as soon as may be, take possession of all the property of the insolvent and realise the property with all convenient dispatch. Out of the sale proceeds of the insolvent's property, the Official Assignee or Receiver must, first of all, retain such sums as may be necessary for meeting the costs of administering (including his remuneration) the insolvent's estate, and then distribute the balance among the creditors in the following order:

1. **Preferential debts.** The following debts or claims must be paid in priority to all other debts:

(a) All debts due to the Government or any local authority, *e.g.*, municipal taxes, land revenue, income-tax, *etc.*

(b) All salary or wages of any clerk, servant or labourer in respect of services rendered to the insolvent during four months before the date of the presentation of the insolvency petition, subject to the following limits:

(i) under the Presidency Towns Insolvency Act — Rs 300 in respect of each clerk and Rs 100 in respect of each servant or labourer;

(ii) under the Provincial Insolvency Act — Rs 20 in respect of each clerk, servant or labourer.

It may be mentioned that excess of the amount of salary or wages over these limits shall be treated as 'unsecured debt'.

(b) Under the Presidency Towns Insolvency Act, rent due to landlord for a period not exceeding one month (arrears of rent exceeding one month shall be treated as unsecured debt). There is no such provision under the Provincial Insolvency Act.

The debts mentioned above rank equally between themselves. These must be paid in full unless the property of the insolvent is insufficient to meet them, in which case they abate in equal proportions between themselves.

2. **Other debts.** If any assets are left after paying the preferential claims mentioned above, they are distributed rateably or proportionately among the unsecured creditors who have proved their debts in insolvency (in the Pres. T. Ins. Act) or whose names have been entered in the Schedule of creditors (in the Prov. Ins. Act).

3. **Payment of interest.** Where there is any surplus after payment of all the foregoing debts in full, it must be applied in payment of interest, at the rate of 6 per cent per annum, for the period after the order of adjudication until the date of actual payment. If there is still any surplus that must be paid to the insolvent.

Administration of partnership property. In the case of insolvency of partners of a firm, the property of the firm is to be applied in the first instance in payment of the debts of the firm, and the separate property of

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each partner is to be applied in the first instance in payment of his separate debts. Where there is a surplus of the separate property of the partners, it must be dealt with as part of the property of the firm, and where there is a surplus of the firm's property, it must be dealt with as part of the respective separate property in proportion to the rights and interests of each partner in the firm's property.

Declaration and Distribution of Dividends

After realising the property of the insolvent, the Official Assignee or Receiver is required to declare and distribute dividend among the creditors with all convenient speed. The creditors are paid, as and when money is collected, in instalments, after keeping aside sufficient amount to meet: *(a)* debts provable in insolvency and due to persons resident so far away that in the ordinary course of communication they have not had sufficient time to tender their proof; *(b)* debts provable but not yet admitted; *(c)* disputed proofs or claims; and *(d)* the necessary expenses for the administration of the estate or otherwise. Each such instalment is called a 'dividend'.

Under the Presidency Towns Insolvency Act, the first instalment *i.e.*, the *first dividend* must be declared and distributed within one year of the adjudication, unless there exists sufficient reason for its postponement to the satisfaction of the Court. *Subsequent dividends* must be declared and be payable at intervals of not more than six months, until the whole estate has been distributed, unless there is sufficient reason for further delay. After declaring dividend, the Official Assignee is also required to send to each creditor who has proved, notice showing the amount of dividend and how it is payable *i.e.*, the time and manner of its payment. But no such time period is fixed under the Provincial Insolvency Act, and the Official Receiver is expected to do all this with convenient speed.

Final dividend. When the Official Assignee or Receiver has realised all the property of the insolvent, or so much thereof, as can, in his opinion (or in the opinion of the Court in the Prov. Ins. Act), be realised without needlessly protracting the proceedings in insolvency, he shall, with the leave of the Court (in the Prov. Ins. Act no permission of the Court is required), declare a *final dividend.* But before so doing, he must give notice to the persons whose claims have not been proved that, if they do not prove their claims within the time specified by the notice, he will proceed to make a *final dividend* without regard to their claims. If the concerned creditors do not comply with the notice within the time so prescribed, they shall be ignored and a final dividend will be declared.

ANNULMENT OF ADJUDICATION

An order of adjudication shall be annulled or cancelled in any of the following circumstances:

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1. Where the order of adjudication was wrongly made. For *example,* where it is proved that *(i)* the person adjudicated insolvent is a minor or lunatic or was dead at the time of petition, *or (ii)* the Court had no jurisdiction to make the adjudication order, *or (iii)* the Order was passed on the petition of a person who was not entitled to present such a petition, *e.g.,* on a petition of a creditor to whom the debtor owed less than Rs 500.

2. Where it is proved to the satisfaction of the Court that the debts of the insolvent have been paid in full.

3. Where it is proved to the satisfaction of the Court that insolvency proceedings are pending in any other Court in India against the same debtor and the property of the debtor can be more conveniently distributed by such other Court.

4. Where a proposal for a 'composition' or a 'scheme of arrangement' is approved by the Court.

5. Where the insolvent absents himself on the date fixed for hearing his application for 'discharge', or does not apply for an 'order of discharge' within the period specified by the Court.

6. Where the adjudication was made on a debtor's petition which was presented without the permission of the Court, although such permission was necessary. (A debtor is required to obtain prior permission of the Court for presenting an insolvency petition where on a prior occasion an order of adjudication passed against him was annulled on account of his failure to apply for his discharge.)

It may be noted that in the last two cases mentioned above, the Court enjoys discretionary power. It may annul the adjudication or make such other order as it thinks just.

An order for annulment of adjudication may be made by the Court *either* on its own motion *or* on an application by the insolvent or any creditor or Official Assignee or Receiver. Notice of every order annulling an adjudication shall be published in the Official Gazette and in such other manner as may be prescribed.

Effects of Annulment of Adjudication

The effects of an order of annulment of adjudication are as follows:

1. All sales and dispositions of property and payments duly made and all acts therefore done by the Official Assignee or Receiver or the Court shall remain valid.

2. The property of the insolvent shall vest in such person as the Court may appoint, or, in default of any such appointment, shall revert to the debtor who was judged insolvent subject to such conditions as the court may impose.

3. Where a debtor has been released from a civil prison on his

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adjudication, the Court may, if it thinks fit, recommit the debtor his former custody, and thereupon all processes which were in force against him at the time of his release again revive.

SMALL INSOLVENCIES

Where the estate of an insolvent is small, both the Insolvency Acts provide for a summary or simplified procedure for the administration of the insolvent's estate with a view to saving expense. The estate of the insolvent is considered to be small if its value is not likely to exceed Rs 3,000 under the Presidency Towns Insolvency Act and Rs 500 under the Provincial Insolvency Act. The insolvencies to be administered in a summary manner are known as 'small insolvencies'.

In case of *small insolvencies*, the provisions of the respective Acts apply as usual, subject to certain modifications. The relevant modifications differ under the two Acts which are stated below:

Modifications under the Provincial Insolvency Act

1. No notice required under the Act shall be published in the Official Gazette, unless the Court otherwise directs.
2. On the admission of a petition by a debtor, the property of the debtor shall vest in the Court as a receiver.
3. At the hearing of the petition, the Court shall inquire into the debts and assets of the debtor and determine the same by order in writing, and it shall not be necessary to frame a Schedule of creditors under the provisions of Section 33.
4. The property of the debtor shall be realised with all reasonable dispatch and thereafter, when practicable, distributed in a single dividend.
5. The debtor shall apply for his discharge within six months from the date of adjudication.
6. Such other modifications as may be prescribed with a view to saving expense and simplifying procedure.

The Court may also, at its discretion, at any time, direct that the estate be administered in the usual way, and the usual procedure shall thereupon be followed.

Modifications under the Presidency Towns Insolvency Act

1. No appeal shall lie from any order of the Court, except with the prior permission of the Court.
2. No examination of the insolvent shall be held, except on the application of a creditor or the Official Assignee.

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3. The estate shall, where practicable, be distributed in single dividend.

4. Such other modifications as may be prescribed with a view to saving expense and simplifying procedure.

The Court may also, if it thinks fit, at any time, revoke the order for the summary administration of the insolvent's estate, and direct for following the ordinary procedure laid down in the Act.

TEST QUESTIONS

1. What property of the insolvent *(i)* is divisible, and *(ii)* is not divisible among his creditors? Explain fully.

2. Explain the doctrine of Reputed Ownership in insolvency and state the conditions which must be fulfilled in order to attract this doctrine.

3. Explain briefly the powers and duties of Official Assignee or Receiver.

4. *(a)* "In matters arising out of insolvency the Official Assignee or Receiver has a higher title than the insolvent." Discuss.

(b) Enumerate the 'preferential payments' in case of insolvency.

5. What is a 'composition' and a 'scheme of arrangement'? What procedure has been laid down under the Insolvency Acts in relation to them? What is the effect of the Court approving the 'Scheme' or 'Composition'? Under what circumstances an approved 'Scheme' or 'Composition' can be annulled by the Court?

6. What do you understand by 'debts provable in insolvency?" Can interest be claimed on provable debts?

7. In distributing the property of an insolvent what debts are entitled to priority over other debts of the insolvent? Are there any rules regarding the declaration and distribution of 'dividends' in insolvency?

8. When can the Insolvency Court annul an order of adjudication? State the effects of an order of annulment of adjudication.

9. *(a)* Write a note on 'disclaimer of onerous property".

(b) What do you understand by "small insolvencies"? What special modifications have been made under the two Insolvency Acts relating to them?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. *P* has large properties movable and immovable in Calcutta, Delhi, New York and Tokyo. Which of these would vest in the Official Assignee or Receiver in case of *P*'s insolvency.

[Hint. All properties except immovable properties in New York and Tokyo would vest in the Official Assignee or Receiver.]

2. *X*, an undischarged insolvent resident of Bombay, obtained a money decree against *Y* for personal services rendered by him after his adjudication and he assigned the decree to *Z*. To whom should *Y* pay the decretal amount — to *Z* or to the Official Assignee?

[Hint. *Y* should pay the decretal amount to *Z*, if the Official Assignee does not intervene, for, under the Presidency Towns Insolvency Act, 'after-acquired prop-

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erty' does not vest in the Official Assignee until he intervenes and claims the property.]

3. *A* entrusts ten bags of wheat to *B*, a commission agent, for sale. Sometimes later, *B* is adjudged an insolvent. The ten bags of wheat still remain unsold with *B*. The Official Receiver as well as *A* claim the goods. Decide?

[**Hint.** *A* is entitled to claim the goods as they are held by the insolvent as a trustee. Moreover, B, the insolvent, cannot be called the 'reputed owner' thereof because *A*, the true owner, has consented only to the possession of the goods by *B* and not to the *reputation of ownership.*]

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Chapter 38

Discharge of Insolvent

'Discharge of the insolvent' is the last stage in the insolvency proceedings. From the date of the 'order of adjudication' to the date from which the 'order of discharge' operates, the insolvent debtor is an 'undischarged insolvent' and suffers from certain personal disqualifications, *i.e.,* loses certain civic rights. It is only after an 'absolute discharge order' is made by the Court that the insolvent gets a fresh start in life, and the insolvent and his after-acquired property is freed from the burden of debts provable in his insolvency (except certain special types of debts). After the 'order of discharge', the stigma of insolvency is removed from the name of the insolvent debtor and he becomes a free man again like an ordinary citizen. The Court therefore is very careful to scrutinise all the facts relating to the insolvency before granting a discharge so that the benefit of freedom from all liability for his debts is extended only to an honest debtor who incurs loss by reason of misfortune and not to one who deals extravagantly or recklessly.

Procedure Regarding Discharge

The Court does not grant a discharge certificate of its own, but the insolvent is required to apply to the Court for an Order of Discharge. Under the Presidency Towns Insolvency Act, he may apply for discharge at any time after the order of adjudication, but the application shall not be heard until his Public Examination is over except where such an Examination has been dispensed with. Under the Provincial Insolvency Act, the insolvent must apply for discharge within the time specified by the Court in the Adjudication Order itself.

Powers of the Court. On receiving the application for discharge the Court fixes a day for the hearing of the application and asks the Official Assignee or Receiver to submit his report regarding the insolvent's conduct as to whether he has aided to the utmost of his power in the realisation of his property and distribution of the proceeds among his creditors. All creditors are also duly notified about the date of hearing. On the appointed date of hearing, the Court hears the insolvent, the creditors and the Official Assignee or Receiver. The Court may put such questions to the insolvent debtor and receive such evidence as it may think fit. After hearing the

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different parties and considering the objections of any creditor and the report of the Official Assignee or Receiver, the Court may:

(a) grant an *absolute* order of discharge; or

(b) grant a *conditional* discharge, attaching such conditions as it thinks fit, *e.g.*, making the order effective after some time *or* making the order subject to conditions as to payments out of the insolvent's future earnings or after-acquired property according to the directions of the Court; or

(c) refuse to grant an order or discharge.

Refusal of Absolute Discharge

An order of discharge which is to take effect immediately and to which no conditions are attached is an absolute or unconditional order of discharge. The Court *must refuse* to grant an 'absolute order of discharge' to the insolvent (it may issue a 'conditional order of discharge') under any of the circumstances mentioned below:

1. When the insolvent's assets are not of a value equal to 25 Paise in the rupee under the Presidency Towns Insolvency Act, and 50 Paise in the rupee under the Provincial Insolvency Act, on the amount of his unsecured liabilities. But if he satisfies the Court that the fact, that the assets are not of such value, has arisen from circumstances for which he cannot justly be held responsible, the Court may grant an 'absolute discharge'.

2. When the insolvent has failed to keep and present such books of account as are usual and proper in the business carried on by him and as sufficiently disclose his business transactions and financial position for the three years immediately preceding his insolvency.

3. When the insolvent has continued to trade after knowing himself to be insolvent *i.e.*, unable to pay his debts in the ordinary course.

4. When the insolvent has contracted any debt without any reasonable expectation that he would be able to pay it.

5. When the insolvent has failed to account satisfactorily for any loss of assets or for any deficiency of assets to meet his liabilities.

6. When the insolvency has been caused by his rash and hazardous speculations, extravagant standard of living, gambling or gross neglect of business affairs.

7. When the insolvent has, within three months preceding the date of the presentation of the insolvency petition, given an undue preference to any of his creditors knowing well that he was unable to pay his debts in full as they become due.

When the insolvent has concealed or removed his property or any part thereof, or has been guilty of any other fraud or fraudulent breach of trust or misconduct in the course of insolvent proceedings.

9. When the insolvent has already been adjudged insolvent on any previous occasion, or has made a Composition or Scheme of Arrangement with his creditors (under the Provincial Insolvency Act only).

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10. When the insolvent has put any of his creditors to unnecessary expense by a frivolous or vexatious defence to any suit properly brought against him (under the Presidency Towns Insolvency Act only).

11. When the insolvent has, within three months preceding the date of presentation of insolvency petition, incurred unjustifiable expense by bringing a frivolous or vexatious suit (under the Presidency Towns Insolvency Act only).

In any of the above cases, the Court shall not grant an 'absolute order of discharge.' It may, however, grant a 'conditional discharge,' attaching such conditions as it thinks just.

Effect of Failure to apply for Discharge

If an insolvent *(a)* does not appear on the day fixed for hearing his application for discharge, or *(b)* does not apply for an order of discharge within the period as may be prescribed, the Court may annul the order of adjudication or make such other order as it may think fit. If the adjudication is so annulled, the usual consequences of annulment of adjudication shall follow.[1]

Effects of Order of Discharge

The effects of an *absolute order of discharge* are as follows:

1. An order of discharge shall release the insolvent from all 'debts provable in insolvency', except the following debts:

(a) any debts due to the Government.

(b) any debt or liability incurred by means of any fraud or fraudulent breach of trust to which he was a party;

(c) any debt or liability in respect of which he has obtained forbearance by any fraud to which he was a party; or

(d) any liability under a 'Maintenance Order' made under the Code of Criminal Procedure. (Such an order is made against a person who neglects to maintain his wife and minor children inspite of sufficient means).

The 'discharged insolvent' continues to be liable for the aforesaid debts and liabilities even after obtaining an absolute order of discharge.

2. An order of discharge shall not release any person who, at the date of the presentation of the insolvency petition, was a co-debtor with the insolvent or was surety for him.

3. An order of discharge removes the personal disqualifications from which an undischarged insolvent suffers.

4. An order of discharge does not relieve the insolvent from debts incurred by him after adjudication, though before discharge, because these are 'debts not provable in insolvency'.

[1]For consequences of annulment of adjudication, refer to the side heading—*"Effects of Annulment of Adjudication"* in the preceding Chapter.

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5. An order of discharge also does not exempt the insolvent from being proceeded against for any criminal offence committed under Indian Penal Code or the Insolvency Acts. The Insolvency Acts prescribe penalties for certain offences committed by an insolvent. For example, *(a)* an undischarged insolvent obtaining credit to the extent of Rs 50 or more from any person without informing such person that he is an undischarged insolvent shall, on conviction by a Magistrate, be punishable with imprisonment for a term upto six months, or with fine or with both; *(b)* an undischarged insolvent wilfully failing to perform the duties imposed on him by the respective Insolvency Acts shall be punishable on conviction with imprisonment which may extend to one year.

It is to be noted that an Order of Discharge does not really operate as a termination of the insolvency proceedings. The powers of the Official Assignee or Receiver to deal with such property of the insolvent as is vested in him at the time of the Order of Discharge do not cease with making of an Order of Discharge and the Court retains power to give directions as to the distribution of assets among the creditors. Under Section 43 of the Presidency Towns Insolvency Act, the Order of Discharge can be revoked if the *discharged insolvent* fails to assist the Official Assignee, when required to do so, in the realisation and distribution of such of his property as is vested in the Official Assignee. There is no such provision under the Provincial Insolvency Act.

TEST QUESTIONS

1. Discuss the procedure regarding 'discharge' of an insolvent. Distinguish between an 'absolute order of discharge' and a 'conditional discharge.'

2. What are the various circumstances under which the Court must refuse an "absolute order of discharge?"

3. Under what circumstances is an insolvent discharged? What are the effects of such a discharge?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons:

1. *A* omitted to prove a 'provable debt' against *B*, an insolvent. Later, *B* was granted a 'discharge' by the Court. Can *A* still recover his debt from *B*?

[**Hint.** No, *A* cannot recover his debt from *B* after his discharge, for, an Order of Discharge releases the insolvent from all 'debts provable in insolvency.']

2. *X* omitted to prove a 'provable debt' against *Y*, an insolvent. *Z* was the surety for the aforesaid debt. Later, *Y* was granted a 'discharge' by the Court. Advise X.

[**Hint.** *X* is advised to proceed against *Z*, the surety, because an Order of Discharge does not release any person who was a surety for the insolvent. It releases only the insolvent from his past debts.]

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PART VII

Law of Carriage of Goods

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Chapter 39

Carriage of Goods by Land

Transport plays a vital role in the economic development of a country. It facilitates the movement of goods and labour. Modern commerce being based pre-eminently on a system of exchange, the role of transport is very important in the development of commerce. Hence, the importance of the study of law relating to 'Contract of Carriage of Goods' is great.

The carriage of goods may take place either by land or by sea or by air. We shall, thus, be studying the Law of Carriage of Goods under three distinct heads: (1) Carriage by Land, (2) Carriage by Sea, and (3) Carriage by Air. The first head is dealt in the present chapter and the latter two heads form the subject-matter of the two successive chapters.

The law relating to *carriage of goods by land* (including inland navigation) is contained in *(a)* The Carriers Act, 1865, and *(b)* The Indian Railways Act, 1890. Both these Acts have been amended several times by now.

Contract of Carriage and Carriers Defined

'A contract whereby a person or company agrees to carry goods or people from one place to another in return for a payment is known as a contract of carriage.' The party who undertakes to carry the goods or people for payment (*e.g.,* a railway, steamship or aircraft company) is called the *carrier.*

Classification of Carriers

Carriers are classified into two categories, namely; *(i)* common carriers, and *(ii)* private carriers.

Common carrier. The Carriers Act, 1865 defines a common carrier as a person including any association or body of persons, whether incorporated or not (other than the Government) engaged in the business of transporting for hire property from place to place, by land or inland navigation, for all persons indiscriminately.

The above definition reveals the following *characteristics* of common carrier:

(i) A common carrier may be an individual, a firm, an association of

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persons or a body corporate, but the Government is not a common carrier within the definition. Thus, Railways (owned and run by the Government) are not governed by the Carriers Act, 1865, although they carry goods. The carriage of goods by Railways is governed by the Indian Railways Act, 1890.

(ii) A common carrier is one who is engaged in the *business* of transporting *goods* for *hire*. From this it follows that one who carries goods occasionally or free of charge is not a common carrier. Also, one who carries passengers is not a common carrier.[1]

(iii) The carriage must be by land or inland navigation.

(iv) A common carrier is one who is bound to carry the goods of any person, who chooses to employ him for the purpose, without any discrimination. If a carrier reserves to himself the right to reject an offer (even if there is accommodation in the carriage and the offeror is prepared to pay the usual freight), he is not a common carrier. Of course, if a carrier offers to carry goods only from one specified place to another or to carry only a particular kind of goods, he is a common carrier.

Exceptions. A common carrier can lawfully refuse to carry the goods under the following circumstances:

(a) if there is no space in his vehicle;

(b) if the goods are not of the type he usually professes to carry;

(c) if the goods are of dangerous nature and subject him to some extraordinary risk;

(d) if the destination to which the goods are to be carried is not on his normal route;

(e) if reasonable charges for the carriage are not paid;

(f) if the goods are not properly packed.

If a common carrier refuses to carry the goods of any person without any of the reasons stated above, he can be sued and made liable for damages *(G.W. Rly. Co.* vs *Sutton*[2]*)*.

Private carrier. A private carrier is one who makes no general offer, but carries goods as a casual occupation and not as a business, and for particular persons on special terms mutually agreed upon. Thus, unlike a common carrier, he is not bound to carry the goods of all and sundry. He enjoys the discretion of accepting or rejecting any proposal for carriage of goods.

A private carrier is not governed by the Carriers Act, 1865. His position

[1] A *carrier of passengers* is not subject to the provisions of the Carriers Act, 1865. He is governed by local statutes like the Motor Vehicles Acts and the Police Acts. We shall not go into the details as our topic is *Carriage of Goods* only and does not include carriage of passengers.

[2] (1869) L.R. 4 H.L. 226

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is that of a bailee.[3] Hence, he is governed by the Indian Contract Act.

Duties of Common Carrier

The Carriers Act, 1865 imposes the following duties on a common carrier:

1. A common carrier is bound to carry goods of the class which he holds himself out as being ready to carry, along his usual route, for any person offering to pay hire, unless his vehicle is already full or the goods are inadequately packed.

2. A common carrier must follow the customary or agreed route. He must not deviate from it unless rendered necessary.

3. He must carry the goods with reasonable care.

4. The carrier must deliver the goods at the place of destination at the agreed time or (if no time had been agreed upon) within a reasonable time.

5. When goods are in transit, the carrier is bound to obey the instructions of the consignor as to alterations of delivery.

Rights of Common Carrier

1. A common carrier is entitled to the agreed remuneration or (if nothing had been agreed upon) to a reasonable remuneration for his services. He can demand payment in advance as well.

2. He has a right to retain the goods and refuse delivery thereof until his charges for the carriage are paid. In other words, he can exercise *particular lien* over the goods.

3. On refusal to accept delivery of the goods by the consignee, the carrier is entitled to take such steps as are reasonable in the circumstances. He can sell the goods if they are of a perishable nature or store them in a warehouse. He can recover warehousing expenses etc. from the consignor. In the absence of privity of contract, the consignee cannot be made liable for such expenses.

4. He can recover damages from the consignor for loss suffered by him because of dangerous nature of goods not being explained to him by the consignor (*Bamfield* vs *Goole and Sheffield Transport Co. Ltd.*[4]).

Liabilities of Common Carrier

Under the English Common Law, a common carrier is an *insurer* of

[3]A bailee is one who receives goods for a specific purpose or period of time on a contract that the goods will be returned on the fulfilment of the purpose or expiry of the time (Sec. 148 of the Indian Contract Act). A bailee is liable for loss caused by his fault or negligence. If he is not negligent, he is not liable. (Secs. 151 and 152 of the Indian Contract Act).

[4](1910) 2 K.B. 94.

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goods handed over to him. He is therefore liable for all loss or damage to the goods even though not negligent *(i.e.,* even if the goods were stolen or damaged in an accident in spite of his best care), except when the loss is caused:

(i) by an act of God, *e.g.,* lightning, earthquake, storm, floods, tempest, etc;

(ii) by country's enemies, *e.g.,* during war;

(iii) by an inherent or latent vice in the goods themselves, *e.g.,* evaporation of liquids, perishing of fruits, disease in animals;

(iv) by the negligence of the consignor, *e.g.,* defective packing.

In India the Carriers Act, 1865 has classified the goods for the purpose of carrier's liability into two categories; *(a)* scheduled goods, and *(b)* non-scheduled goods. *Scheduled goods* include valuable goods such as gold, silver, precious stones, pearls, jewellery, bills and hundis, currency notes, coins, maps, title deeds, opium, government securities, *etc.* A list of such goods has been given in the Act. Goods which have not been included in the list are termed as *Non-scheduled goods*. Regarding the liabilities of a common carrier in respect of the two classes of goods, the provisions of the Carriers Act can be summed up as follows:

1. *As regards non-scheduled goods,* a common carrier's liability is that of an *insurer*[5] of goods carried by him and he is liable for all loss or damage to the goods while they are in the course of transit, except when the loss is caused under the exceptional circumstances as mentioned above under the English Common Law. *But he may limit his liability by entering into a special contract with the consignor.* For example, it may be agreed between the parties (*e.g.,* by stating in the forwarding note) that the carrier will not be responsible for any loss or damage to goods arising from unexpected and unavoidable emergencies, robbers, thieves, dacoits, fire, rain, leakage, and accident.

2. *As regards scheduled goods,* where the value of such goods exceeds Rs. 100, the carrier cannot be held liable, even in spite of negligence on his part; if the value and description of the goods have not been so declared expressly by the consignor at the time of their delivery. Of course where the value and description of the goods are disclosed by the consignor, the carrier will be liable like an insurer for all loss or damage to the goods while they are in transit, except when the loss is caused under the exceptional circumstances as mentioned above under the English Common Law. Further, the carrier cannot limit his liability by any special contract with the consignor (in the case of scheduled goods). He is, however, entitled to charge extra freight for carrying scheduled goods.

[5]Also see *Assam Roadways* vs *National Insurance Co.,* (1979), A.I.R. Cal. 178.

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3. The carrier is always liable (whether the goods are scheduled or non-scheduled) for loss or damage to the goods caused by gross negligence or any criminal act (*e.g.*, deliberate wrong like theft) of the carrier himself, his servant or agent and for unlawful acts or misfeasance (*e.g.*, converting the goods to his own use or knowingly delivering them to a wrong person). It may be noted that this liability cannot be avoided by a special contract with the consignor and any clause in the contract to that effect shall be null and void and inoperative.

Section 10 of the Carriers Act provides that in case of loss or damage the claimant must notify in writing his claim to the carriers within six months of the date when he first knew of such loss or injury.

RAILWAYS AS CARRIERS

Rail transport is regarded as one of the chief means of land transport in the modern world. As observed earlier, railways, as carriers of goods, are not governed by the Carriers Act, 1865, because they are owned and operated by the Government. The carriage of goods by railways is governed by the Indian Railways Act, 1890, as amended up-to-date. The 'railway administration' looks after the administration and working of railways.

Goods may be transported by railways either in 'goods trains' or in 'passenger trains'. Perishable goods and small packages are mainly transported by passenger trains. This ensures quicker delivery but involves higher freight charges.

Forwarding note (Sec. 72). Every consignor of goods or animals has to execute a note in the form prescribed by the railway administration and approved by the Central Government. This note is referred as the 'forwarding note' or 'consignment note.' There are different types of forms available for different types of goods. The forwarding note contains the description of goods, number of packages, weight, the names and addresses of the consignor and consignee, the extent of the liability of the railway administration for loss or damage and is marked either 'Freight Paid' or 'Freight to pay' accordingly as consignor pays the freight or consignee is to pay the freight. The terms and conditions on which goods are carried by the railway are printed on the back of the note.

Railway receipt (R/R). On submission of the *forwarding note* to the railway 'parcel office,' the consignor is given a receipt acknowledging the goods and giving an undertaking to carry them in accordance with the instructions and subject to the terms and conditions printed on the back of the forwarding note. This receipt is referred as the 'railway receipt' (R/R) and serves as a document of title to the goods. The consignor must send the *railway receipt* to the consignee because it must be presented to the railway

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office at the destination to take delivery of the goods.

Duties of Railway Administration

Under the Indian Railways Act, 1890, the duties of railway administration are as follows:

1. Duty to afford all reasonable facilities for the receiving, forwarding and delivering of traffic without unreasonable delay (Sec. 27).

2. Duty not to give any undue or unreasonable preference or advantage to, or in favour of, any particular person, or any particular description of traffic, in any respect whatsoever, *or* subject any particular person or any particular description of traffic to any undue or unreasonable prejudice or disadvantage in any respect whatsoever (Sec. 28).

3. Duty to comply with any directions given by the Central Government in regard to transport of goods (Sec. 27 *A)*. By virtue of Section 27 *A,* the Central Government is empowered to direct by order any railway administration *(i.e.,* manager of the railway):

(a) to give special facilities for, or preference to, the transport of any such goods or class of goods consigned to the Central Government or any State Government or of such other goods or class of goods, as may be specified in the order;

(b) to carry any goods or class of goods by such route or routes and at such rates as may be specified in the order.

The Section further states that any action taken by a railway administration in pursuance of any such direction shall not be deemed to be a contravention of Section 28 (see point 2 above). Again, any order so made shall cease to have effect after the expiry of six months from the date thereof, but it may be renewed from time to time.

Thus, the railway administration is bound to carry goods of every person who is prepared to pay the necessary freight and observes the regulations regarding packing, etc., without unreasonable delay and without partiality, and to comply with any direction given by the Central Government in public interest in that regard.

Liabilities of Railway Administration

Liability during transit. The liability of the railway administration for the loss, destruction, damage or deterioration, in transit of animals or goods delivered to it for carriage by railway will depend upon the consignor's instructions in the 'forwarding note' as to whether the goods are to be carried at 'railway's risk' or 'owner's risk'.

If the goods are carried at *Railway's Risk*, the railway administration is responsible for any loss or destruction etc., in transit, in respect of the goods, arising from any cause except the following:

(a) act of God;

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(b) act of war;

(c) act of public enemies;

(d) arrest, restraint or seizure under legal process;

(e) order or restrictions imposed by the Central or a State Government or by any officer or authority subordinate to the Central or a State Government authorised in this behalf;

(f) act or omission or negligence of the consignor or the consignee or the agent or servant of either;

(g) natural deterioration or wastage in the bulk or weight due to inherent defect, quality or vice of the goods;

(h) latent defects;

(i) fire, explosion or any unforeseen risk.

Even where the loss or destruction *etc.*, is proved to have arisen from any one or more of the exceptional cases noted above, the railway administration shall not be relieved of its responsibility for the loss or damage unless the administration further proves that it has used reasonable foresight and care in the carriage of the animals or goods (Sec. 73). In effect Section 73 makes the liability of the railway administration the same as that of an insurer of goods, in case the goods are sent at Railway's Risk. Thus, the railway administration will be liable if the goods are stolen while in its custody, even without negligence on its part.

Where the goods are carried at *Owner's Risk*, the railway administration cannot be made liable for any loss, destruction or damage, in transit, of such goods from whatever cause arising, except upon the proof that such loss or damage was due to negligence or misconduct on the part of the railway administration or of any of its servants (Sec. 74). In other words, when goods are sent at Owner's Risk, the railway administration is liable for loss or damage to goods as a 'bailee'.

The 'Railway Risk Rate' is higher than the 'Owner's Risk Rate'. The animals or goods shall be deemed to have been tendered to be carried at *owner's risk rate,* unless the sender or his agent elects in writing to pay the *railway risk rate.* In the latter case, the railway administration will issue a certificate to the consignor to that effect (Sec. 74.).

Liability for delay or detention in transit (Sec. 76). The railway administration is responsible for loss, destruction, damage or deterioration of animals or goods caused by delay or detention in their carriage unless it proves that the delay or detention arose without negligence or misconduct on its part or of any of its servants.

Liability for wrong delivery (Sec. 76*B*). Where the railway administration delivers the goods or animals in good faith to a person who produces the original railway receipt, it shall not be responsible on the ground that such person is not legally entitled thereto or that the endorsement on the railway receipt is forged or otherwise defective.

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Liability after termination of transit (Sec. 77). Transit terminates on the expiry of the free time allowed (after the arrival of consignment at destination) for its unloading from railway wagon without payment of *demurrage,* and where such unloading has been completed within the free time so allowed, transit terminates on the expiry of the free time allowed for the removal of the animals or goods from railway premises without payment of *wharfage.*

The liability of railway administration *during seven days* after the termination of transit is the same as that of a 'bailee' under Sections 151, 152 and 161 of the Indian Contract Act, for the loss, destruction etc., of goods, whether the goods are carried at 'owner's risk rate' or 'railway risk rate'. Thus, even where goods are carried at 'railway risk rate,' the liability of railway administration *during seven days* after the termination of transit is reduced to that of a bailee. The railway administration shall be liable only if the loss or damage occurs because of negligence or misconduct on its part or of any of its servants.

Regarding the articles of special value like gold, sliver, etc., (mentioned in the Second Schedule to the Railways Act), animals and explosives and other dangerous goods carried by railway, the railway administration is not liable for the loss, destruction etc., even in spite of negligence on its part, after the termination of transit.

After the expiry of *seven days* after the termination of transit, the railway administration is not liable at all in any case for the loss, destruction etc., of goods carried by railway.

It may be noted that the exoneration from liability of the railway administration does not relieve the owner of animals or goods from liability to any *demurrage* or *wharfage* for as long as the animals or goods are not unloaded from the railway wagons or removed from the railway premises.

Liability as a carrier of animals (Sec. 77*A*). In the case of animals, the liability of railway administration for loss or damage etc., shall not exceed the amount specified in the First Schedule to the Act. The limits of liability as laid down in the First Schedule are as follows: elephants — Rs 1,500 per head; horse — Rs 750 per head; mules, horned cattle or camels— Rs 200 per head; dogs, donkeys, goats, pigs, sheep or other animals not mentioned above or birds — Rs 30 per head. The railway may, however, accept a higher liability if the consignor declares a higher value in the 'forwarding note' and pays a higher freight. The railway is in no case responsible where the loss occurs due to freight or restiveness of the animal or overloading of wagon by the consignor or his agent.

Liability in case of articles of special value (Sec. 77*B*). Notwithstanding anything stated earlier, when any articles mentioned in the Second Schedule to the Act (*i.e.,* valuable goods like gold, silver, coins, and

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jewellery *etc.*) are contained in any parcel or package delivered for carriage and the value of such articles in the parcel or package exceeds *five hundred* rupees, the railway administration shall not be responsible for the loss, destruction *etc.*, of the parcel or package *unless* the consignor declared the value and contents thereof in the 'forwarding note,' and if so required by the administration, paid a higher freight by way of compensation for the increased risk. If the requisite declaration is not made, the railway is not responsible at all.

Exoneration from responsibility in certain cases (Sec. 78). Notwithstanding anything stated earlier (under the side-heading: 'Liabilities of Railway Administration'), the railway administration shall not be responsible for the loss, destruction, damage, deterioration or non-delivery of any goods or animals in the following cases:

(a) Where the goods have been despatched with a false description and the loss or damage is, in any way, brought about by the false description.

(b) Where a fraud has been practised by the consignor or the consignee or an agent of either.

(c) Where it is proved by the railway administration that the loss or damage etc., is caused by — *(i)* improper loading or unloading by the consignor or the consignee or an agent of either, or *(ii)* riot, civil commotion, strike, lock-out, stoppage or restraint of labour from whatever cause, whether partial or general.

Further, the railway administration shall also not be responsible for any indirect or consequential damages or for loss of particular market.

Notification of Claims (Sec. 78*B*)

A person shall not be entitled to a refund of an overcharge in respect of animals or goods carried by railway or to compensation for the loss, destruction, damage, deterioration or non-delivery of animals or goods delivered to be so carried, unless his claim to the refund or compensation has been forwarded in writing by him or on his behalf:

(a) to the railway administration to which the animals or goods were delivered for carriage; or

(b) to the railway administration on whose railway the destination station lies, or the loss, destruction, damage or deterioration occurs.

The claim must be made within six months from the date of the delivery of the animals or goods for carriage by railway. The notice of claim may be given to the chief commercial superintendent or the manager of the Railway.

TEST QUESTIONS

1. Define the term 'common carrier.' Distinguish between a 'common carrier'

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and a 'private carrier.' What are the duties of a 'common carrier'?

2. State the duties, rights and liabilities of a 'common carrier.'

3. Discuss the duties and liabilities of railway administration as a carrier of animals and goods.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. An elephant was entrusted by *P* to the railway for carriage from Delhi to Madras. As a result of loose shunting in transit, the elephant fell and broke one of his legs, and it became necessary to shoot him. *P* claims Rs 10,000 as damages for the loss of his elephant. Is his claim justifiable?

[**Hint.** *P*'s claim is justified as the loss of the elephant resulted from the negligence and misconduct of the railway servants in loose shunting, provided he had declared the value of the elephant at the time of booking and paid the higher freight. If he had not done so, then he will be entitled to get only Rs 1,500, which is the maximum amount specified in the Railways Act for the loss of an elephant.]

2. *M* consigned a glass show-case by railway. The case was not properly packed and the railway administration knew of this when it was delivered for carriage. The case is damaged in course of transit. Discuss the liability of the railway administration.

[**Hint.** The railway administration is not liable as the loss has arisen from the negligence of the consignor.]

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Chapter 40

Carriage of Goods by Sea

The law relating to *carriage of goods by sea* is contained mainly in *(i)* The Indian Bills of Lading Act, 1856, and *(ii)* The Carriage of Goods by Sea Act, 1925. The other related Acts governing this subject are — *(a)* The Merchant Shipping Act, 1958, and *(b)* The Marine Insurance Act, 1963. These Acts have been modified several times by now.

Contract of Affreightment

A contract for the carriage of goods by sea is called as a 'contract of affreightment'. The word 'affreightment' literally means 'the hiring of a vessel or ship.' It may, thus, be defined as a contract between the consignor or shipper and the shipping company whereby the former agrees to hire, at a price called 'freight', space in a ship for transportation of goods. A contract of affreightment may be embodied either in a Charter Party or a Bill of Lading.

Charter Party

A 'charter party' is a contract of affreightment entered into for hiring the whole ship or a principal part thereof to carry goods from one port to another. It also refers to the formal written document in which the contract of hiring of the whole or part of the ship for the conveyance of goods is expressed. The person hiring the ship or a part of it is called the 'charterer.'

A charter party may be either *(i)* a *voyage charter, i.e.,* when the vessel is chartered for a particular voyage, or *(ii)* a *time charter i.e.,* when the vessel is hired for a specified period of time, irrespective of the number of voyages performed.

In the case of hiring the whole ship, the terms of the charter party may sometimes amount to a lease or demise of the ship, whereby the possession of the ship comes under the absolute control of the charterer who becomes temporarily the owner of the ship and the captain and the crew become his servants. This is called a *'charter by demise.'* Generally, a charter party is without a demise or lease of the ship where, like a simple contract of carriage, the charterer only gets the right to have his goods conveyed by the

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ship and the captain and the crew do not become his servants and the possession and control of the ship remain with the shipowner. In such a case it is called a *'charter without demise.*

In the case of a 'charter without demise' or where only a part of the ship is hired, that is, where the owner of the ship retains himself the possession and control of the ship and the crew, upon delivering the goods on board the ship, a bill of lading signed by the owner or captain of the ship is given to the charterer as an acknowledgement of the receipt of the goods. It is important to note that a bill of lading issued under a charter party is only a receipt of the goods (the evidence of contract being 'charter party'), and is quite different from the bill of lading issued in the case of a 'general ship' where it is the evidence of the contract of carriage.

Clauses of a charter party. A charter party contains all the essential terms and conditions of the contract between the charterer and the shipowner. It usually contains clauses dealing with the following matters:

1. Names of the parties and of the ship, along with the nationality of the ship and its tonnage as per the Shipping Register of the country of origin.

2. The class of charter party, *i.e.*, whether a 'voyage charter' or a 'time charter', and whether a 'charter by demise' or a 'charter without demise.'

3. Location of the ship, place of loading, manner of loading and the duties of the charterer and shipowner as regards loading and unloading, *(i.e.,* the number of days called '*lay days*' within which the ship is to be loaded or discharged and the payment of demurrage by the charterer in case of delay beyond the 'lay days').

4. A statement that the cargo shall be 'lawful merchandise' both at the port of dispatch and the port of discharge.

5. The names of the places between which the ship is to go.

6. The weight or volume of goods that would be shipped.

7. The liabilities of the charterer regarding payment of freight, *i.e.,* whether it is payable in advance or payable after the completion of the entire voyage. The amount of 'dead freight', if any, which the charterer would have to pay if he fails to produce or load the agreed amount of cargo.

8. The duties of the Master or the Captain.

9. The 'excepted perils,' *i.e.,* an enumeration of the circumstances under which the shipowner does not accept any responsibility for loss or damage to goods, *e.g.,* loss or damage arising from act of God, perils of the sea, enemy action, etc.

10. Circumstances under which the contract shall be deemed as cancelled and the penalties to which the parties shall be liable for breach of contract.

Implied Warranties. In addition to the matters mentioned above, in all

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contracts of carriage by sea, the following terms are implied by law which may or may not be expressly provided in a charter party:

(a) The ship is *seaworthy* at the commencement of the proposed voyage, *i.e.,* the ship is reasonably fit to encounter the ordinary perils of the sea during voyage.[1]

(b) The ship *shall be ready to commence the voyage* and shall carry out the same with all reasonable dispatch and deligence.

(c) The ship *shall not deviate* from the agreed or customary route except for good cause, such as, to ensure safety of the ship, to effect repairs to protect the ship from further damage or to save human life.

(d) The charterer or the shipper *shall not include in his cargo illegal* or contraband goods, or goods which are *dangerous.*

Effects of breach. The effects of any violation or breach of the terms of charter party (including the implied warranties) are as follows:

(i) If any breach of terms is discovered before the commencement of the voyage, the aggrieved party can repudiate the contract and also claim damages.

(ii) If any breach of terms comes to the knowledge after the voyage has begun, the aggrieved party can claim damages.

(iii) In the event of unauthorised deviation of the ship from the agreed or customary route, the shipowner ceases to be covered by the 'excepted perils' clause.

Bill of Lading

A 'bill of lading' is a document issued by the shipowner or by the master or captain of the ship *or* other agent in exchange of Mate's Receipt[2] after the goods have been placed on board the ship for being carried to a specific destination. It is used when the goods shipped form only a part of the cargo of a 'general ship.' In the case of hiring an entire ship, a charter party is drawn up.

A bill of lading must be stamped and signed by the shipowner or his agent *i.e.,* the master or captain of the ship. Under the Carriage of Goods

[1]A ship is 'unseaworthy' when the materials of which she is made, her construction, the qualifications of the master, the number, description and qualifications of the crew including officers, the weight, description and stowage of the cargo and ballast, the condition of her hull and equipment boilers and machinery are not such as to render her in every respect fit for the proposed voyage or service [Sec. 334(5) of the Merchant Shipping Act, 1958].

[2]When goods are delivered to a ship for carriage, a receipt is issued by the Mate of the ship; who is an officer under the Captain, acknowledging that he has received the goods specified therein on board. This is known as *Mate's Receipt.* It is a provisional or interim receipt which is subsequently exchanged for a regular Bill of Lading.

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by Sea Act, 1925, a bill of lading, apart from the main terms of contract, must contain the following particulars:

(a) The leading marks necessary for identification of the goods, provided such marks are stamped on the cases or coverings in which such goods are contained in such a manner as should ordinarily remain legible until the end of the voyage.

(b) The number of packages or pieces, or the quantity, or weight, as the case may be, as furnished in writing by the shipper.

(c) The apparent order and condition of the goods.

When it is stated in a bill of lading that the goods are in good order and condition, the bill is said to be a *'Clean Bill of Lading'*. When it is stated that goods received are in a bad condition, the bill of loading in that case is called a *'Qualified Bill of Lading.'* When the cargo covered by a bill of lading is to be carried partly by sea and partly by land and a composite freight has been charged for sea and land transportation, the bill of lading is called a *'Through Bill of Lading'*.

Characteristics of a bill of lading. A bill of lading has the following distinctive features:

1. It is a *prima facie evidence of the receipt,* by the carrier, of the goods as therein described.

2. It is an *evidence of the contract of affreightment* (where the goods are placed on a 'general ship') whereby the shipping company undertakes to carry the goods and to deliver them to the person named therein or his assignees, on payment of freight.

3. It is a *'document of title'* to the goods. It enables the holder to obtain delivery of goods. Its possession is in law equivalent to the possession of goods and therefore its transfer is symbolically a transfer of the goods themselves. It can be transferred by endorsement and delivery passing to the endorsee same rights as the endorser *(i.e.,* making the endorsee owner of the goods covered thereunder).

Under the Indian Bills of Lading Act, 1856, the consignee and endorsee of a bill of lading have the same rights in relation to the carrier and are subject to the same obligations as the original party to the bill of lading. But for this provision, the consignee or endorsee (who are third parties) would not have any rights under the contract, for, under the general law, a contract creates rights and obligations only between the parties thereto and a third person who is not a party to the contract does not acquire any right thereunder, nor is he subject to any obligations.

4. It is a *semi-negotiable instrument,* that is, although it resembles a negotiable instrument in that it can be transferred freely by endorsement and delivery and its transferee can sue in his own name and can give a valid discharge to the person liable but it is not a negotiable instrument in the

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strict legal sense of the term inasmuch as that the transferee, even though he takes the bill *bonafide* and gives value for it, acquires no better title than what the transferor had. (In the case of a negotiable instrument a *bonafide* transferee for value becomes a 'holder in due course' and gets a good title even in cases where the title of the transferor is defective.)

Differences between a Bill of Lading and a Charter Party

The two documents differ from each other in the following respects:

1. A bill of lading is an evidence of the receipt of the goods on board the ship as well as an evidence of the contract for the carriage of goods. A charter party is only a contract relating to the hiring of the entire or principal part of the ship.

2. A bill of lading is a document of title to the goods specified therein, a charter party is not such a document.

3. A bill of lading, being a document of title to the goods, can be transferred by endorsement and delivery. A charter party is not transferable since it is a contract of hire.

4. A charter party may amount to a lease of the ship, a bill of lading conveys no such implication.

5. A charter party may be for a particular voyage (a voyage charter) or for a particular period of time (a time charter), whereas a bill of lading is always for a particular destination.

Right of Stoppage in Transit

The Indian Bills of Lading Act, 1856 does not affect the provisions regarding unpaid seller's right of stoppage of goods in transit as given under the Sale of Goods Act. Accordingly, the shipping company is not required to deliver the goods to the holder of Bill of Lading if the consignor, in exercise of the right of stoppage in transit, gives instructions not to deliver the goods.

Duties of a Carrier by Sea

The Carriage of Goods by Sea Act, 1925 lays down that under every contract of carriage of goods by sea the carrier shall be subject to the following responsibilities:

1. The carrier, *i.e.,* the shipowner shall be bound, before and at the beginning of the voyage, to exercise due diligence to:

(a) make the ship seaworthy;

(b) properly man, equip and supply the ship;

(c) make the holds, refrigerating and cool chambers, and all other parts of the ship in which goods are carried, fit and safe for their reception, carriage and preservation.

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2. The carrier must properly and carefully load, handle, stow, carry, keep, care for and discharge the goods carried.

3. After receiving the goods into his charge, the carrier or the master or agent of the carrier must, on demand of the shipper, issue to the shipper a bill of lading containing the prescribed particulars.

Liabilities of Carrier by Sea

The Carriage of Goods by Sea Act, 1925 lays down the following rules regarding the liabilities of a carrier of goods by sea:

1. A carrier of goods by sea, *i.e,* a shipowner is liable only for loss or damage arising or resulting from his negligence, fault or failure in the duties and obligations provided in the Act, and not otherwise. He is not liable even for the loss caused by the neglect or default of the master, mariner, pilot, or the crew in the navigation or in the management of the ship. He is not an insurer of goods carried by the ship. For insurance against sea perils, separate 'Marine Insurance Policy' is to be taken.

2. A shipowner cannot limit or lessen his liability arising from his negligence or failure in the duties and any clause in the contract to that effect shall be null and void and inoperative.

3. The carrier shall not be liable in any event for any loss or damage to the goods in an amount exceeding £ 100 per package or unit, unless the nature and value of such goods have been declared by the shipper before shipment and inserted in the bill of lading. But the carrier and the shipper may, by agreement, fix another maximum amount than that mentioned in this paragraph, provided that such maximum shall not be less than the figure above named.

4. The carrier shall not be liable in any event for loss or damage to the goods if the nature or value thereof has been knowingly misstated by the shipper in the bill of lading.

5. Goods of an inflammable, explosive or dangerous nature to the shipment whereof the carrier, master or agent of the carrier, has not consented, with knowledge of their nature and character, may, at any time before discharge, be landed at any place or destroyed or rendered innocuous by the carrier *without compensation,* and the shipper of such goods shall be liable for all damages and expenses directly or indirectly arising out of or resulting from such shipment. Further, if any such goods shipped with such knowledge and consent shall become a danger to the ship or cargo, they may in like manner be landed at any place or destroyed or rendered innocuous by the carrier *without liability* on the part of the carrier except to 'general average,'[3] if any.

[3]For details of 'general average' and 'particular average' loss, refer to the Chapter of Marine Insurance.

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6. The carrier shall be discharged from all liability for loss or damage unless suit is brought within one year after delivery of the goods or the date when the goods should have been delivered.

Shipowner's Lien and Maritime Lien

A 'shipowner's lien' is the right of a shipowner to retain possession of the goods (cargo) carried by him until freight and other charges due to him under the contract of carriage have been paid. It is a possessory lien.

A 'maritime lien' is a claim on a ship, cargo and the freight in respect of services rendered to them. This right is given by law to all persons who have rendered some service to save the ship or cargo in time of danger. By virtue of this right, they can recover their charges from the shipowner or cargoowner. Until their charges are paid, the ship is not allowed to leave harbour and the Court may order for sale of the ship or cargo in favour of the holders of maritime lien. This lien is possessed by the following persons:

(i) seamen for their wages;

(ii) the holder of a 'bottomry bond' for his dues;

(iii) salvors, *i.e.*, persons who rescue ship or property from the ship for charges in connection with salvage;

(iv) persons who have a claim against the ship, for damages caused by collision due to negligence.

A *maritime lien* can be exercised independently of any possession by filing a suit in the appropriate court.

Bottomry and Respondentia Bonds

When a ship needs urgent repairs in course of its voyage and it is not possible for the master of captain of the ship to communicate with the shipowner to arrange the necessary funds, it becomes necessary for the captain of the ship to borrow money on the security of the ship, cargo or freight by executing a bond. The bond by which the ship, cargo and freight are hypothecated is known as a Bottomry Bond. But if the cargo only is hypothecated, the bond is known as a Respondentia Bond.

The special feature of these bonds is that the amount of loan is payable only, if the ship reaches its destination safely. If more than one such bond is executed during the same voyage, the holder of the last bond has a prior claim over the earlier bondholders.

TEST QUESTIONS

1. What is a Charter Party? What are the usual express and implied terms in a Charter Party? What is the effect of breach of any of them?

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2. Define a contract of affreightment. What are the implied warranties in a contract of carriage by sea? If any of them is broken, what is the legal consequence?

3. What is a bill of lading? What are the characteristics of a bill of lading? Distinguish a bill of lading from a charter party.

4. What are the duties and liabilities of a carrier under the Carriage of Goods by Sea Act, 1925.

5. Write notes on: *(a)* Shipowner's lien and Maritime lien; *(b)* Bottomry and Respondentia bonds.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *B,* a carrier, issued a bill of lading acknowledging receipt of a package of cashewnuts (as per the shipper's statement). In fact the package contained groundnuts. In unloading the ship the stevedores employed by the shipowner damaged the goods through negligence. Is the carrier liable for the loss?

[**Hint.** No, the carrier is not liable for the loss to the goods because the nature and value thereof has been knowingly mis-stated by the shipper.]

2. *X* held, as indorsee, a bill of lading for 100 bales of cotton shipped from Bombay to Liverpool. During the voyage, the ship deviated and called at a port not lying on the prescribed route. Thereafter the ship resumed the prescribed route and proceeded on her voyage. But while nearing Liverpool the ship was sunk by an enemy submarine. Is the shipowner liable to *X* for the loss?

[**Hint.** The rights and liabilities of *X,* the indorsee, are the same as those of the original holder of the bill of lading. Hence the shipowner is liable to *X* for the loss because the ship has deviated from its prescribed route. The law on the point being that in the event of unauthorised deviation of the ship from the prescribed route, the shipowner ceases to be covered by the 'excepted perils' clause.]

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Chapter 41

Carriage by Air

The law relating to *carriage by air is* contained in the Carriage by Air Act, 1972. This Act repeals the Indian Carriage by Air Act, 1934.[1] The new Act was passed to give effect to the Convention for the unification of certain rules relating to international carriage by air signed at Warsaw in 1929 and to the said Convention as amended by the Hague Protocol in 1955 and to make provision for applying the rules contained in the said Convention in its original form and in the amended form (subject to exceptions, adaptations and modifications) to non-international carriage by air and for matters connected therewith.

The Carriage by Air Act, 1972 contains two schedules. Schedule I contains the Warsaw Convention rules which are applicable to international carriage by air of countries which have not yet signed the Hague Protocol. Schedule II contains the amended rules (as amended by the Hague Protocol in 1955) applicable to international carriage by air of countries which have signed the Hague Protocol. Fifty-seven countries have already ratified the Hague Protocol. The Central Government is empowered to make the rules contained in the aforesaid Schedules I and II applicable to the internal carriage by air by a notification in the Official Gazette subject, however, to such exceptions, adaptations and modifications, if any, as may be specified (Sec. 8).

It may be pointed out that the rates of air freight being very high, air transport is not a popular mode of transport of goods. Generally this mode of transport is suitable for the transportation of light and costly goods and carriage of passengers.

The amended rules relating to international carriage of persons, baggage or cargo, as contained in the Second Schedule to the Carriage by Air Act, 1972, are summarised below:[2]

[1]The Indian Carriage by Air Act, 1934 was enacted to enforce the rules relating to international carriage by air contained in the Convention of 1929 held in Warsaw.

[2]The rules shall not apply to carriage of mail and postal packages [Rule (2)].

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Definitions

High contracting party. The term "High Contracting Party" means all the governments of countries originally signatories to the Warsaw Convention Rules as amended by the Hague Protocol (*i.e.*, to the amended Convention), together with those who adhere thereto subsequently. India is a signatory to the amended Convention, and is, therefore, a High Contracting Party [Rule 1(2)].

International carriage. The expression 'international carriage' means any carriage in which, according to the agreement between the parties, the place of departure and the place of destination, whether or not there be a break in the carriage or a transhipment, are situated either within the territories of two High Contracting Parties or within the territory of a single High Contracting Party if there is an agreed stopping place within the territory of another State, even if that State is not a High Contracting Party. Carriage between two points within the territory of a single High Contracting Party without an agreed stopping place within the territory of another State is not international carriage [Rule 1(3)].

Documents of Carriage

Chapter II of the Second Schedule to the Carriage by Air Act, 1972 provides that when goods and passengers are carried by air, the following 'documents of carriage' are to be issued:

1. **Passenger ticket** (Rule 3). For the carriage of passengers, the carrier must deliver a *passenger ticket* containing the following particulars:

(a) an indication of the places of departure and destination;

(b) if the places of departure and destination are within the territory of a single High Contracting Party, one or more agreed stopping places being within the territory of another State, an indication of at least one such stopping place;

(c) a notice to the effect that, if the passenger's journey involves an ultimate destination or stop in a country other than the country of departure, the provisions of the Second Schedule to the Carriage by Air Act, 1972 shall be applicable to the contract of carriage.

The passenger ticket shall constitute *prima facie* evidence of the conclusion and conditions of the contract of carriage. The absence, irregularity or loss of the passenger ticket does not affect the existence or the validity of the contract of carriage. But, if a passenger is allowed to board the aircraft by the carrier without a passenger ticket, or if the ticket does not include the notice required by sub-rule *(c)* stated above, the carrier shall not be entitled to the benefit of the provisions of Rule 22 (which limits his liability for death or personal injury to the sum of 2,50,000 francs).

2. **Baggage check** (or Luggage ticket) (Rule 4). For the carriage of

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registered baggage (*i.e.*, luggage other than small personal objects of which the passenger takes charge himself), the carrier must deliver a *baggage check* to the passenger. The baggage check, unless combined with or incorporated in a passenger ticket containing prescribed particulars, must contain all the particulars necessary to be included in a passenger ticket and in addition must mention *(i)* the number and weight of the packages, *(ii)* the value, as declared by the passenger, of the baggage booked, and *(iii)* a statement that the delivery, of the baggage will be made to the bearer of the 'baggage check.'

The baggage check shall constitute *prima facie* evidence of the registration of the baggage and of the conditions of the contract of carriage. The absence, irregularity or loss of the baggage check does not affect the existence or the validity of the contract of carriage. But, if the carrier accepts baggage without delivering a baggage check, he shall not be entitled to the benefit of the provisions of sub-rule (2) of Rule 22 (which limits his liability in respect of loss of, or damage to, baggage to a sum of 250 francs per kilogramme).

3. **Air waybill** (or Air consignment note). In the case of carriage of goods or cargo by air, every carrier of cargo has the right to require the consignor to make out and hand over to him a document called an 'air waybill', and every consignor has the right to require the carrier to accept this document. The absence, irregularity or loss of this document does not affect the existence or the validity of the contract of carriage (Rule 5). But, if the carrier allows the loading of cargo on board the aircraft without an air waybill having been made out and delivered to him, he shall not be entitled to the benefit of the provisions of sub-rule (2) of Rule 22 (which limits his liability in respect of loss of, or damage to, cargo to a sum of 250 francs per kilogramme) (Rule 9).

The air waybill shall be made out by the consignor in three original parts and be handed over with the cargo. The *first part* shall be marked 'for the carrier' and shall be signed by the consignor. The *second part* shall be marked 'for the consignee' and shall be signed by the consignor and by the carrier and shall accompany the cargo. The *third part* shall be signed by the the carrier and handed over by him to the consignor after the cargo has been accepted. The carrier shall sign prior to the loading of the cargo on board the aircraft. The signature of the carrier may be stamped; that of the consignor may be printed or stamped. If, at the request of the consignor, the carrier makes out the air waybill, he shall be deemed, subject to proof to the contrary, to have done so on behalf of the consignor (Rule 6).

The carrier of cargo has the right to require the consignor to make out separate waybills when there is more than one package (Rule 7).

Contents. The air waybill must contain the following particulars:

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(a) an indication of the places of departure and destination;

(b) if the places of departure and destination are within the territory of a single High Contracting Party, one or more agreed stopping places being within the territory of another State, an indication of at least one such stopping place;

(c) a notice to the consignor to the effect that, if the carriage involves an ultimate destination or stop in a country other than the country of departure, the provisions of the Second Schedule to the Carriage by Air Act, 1972 shall be applicable to the contract of carriage (Rule 8).

In addition to the above particulars, the air waybill must also mention *(i)* the names and addresses of the consignor, consignee and the first carrier, *(ii)* the nature of goods, *(iii)* the number and weight of packages, *(iv)* the apparent condition of the goods and of the packing, *(v)* the amount of the freight, the date and place of payment and the person who is to pay it, *(vi)* the amount of the value of goods declared by the consignor, *(vii)* the documents handed over to the carrier to accompany the air waybill, and *(viii)* the time fixed for the completion of the carriage and the route to be followed (if these matters have been agreed upon).

Further, the consignor must also furnish such information and attach to the air waybill such documents as are necessary to meet the formalities of customs, octroi or police before the cargo can be delivered to the consignee. The consignor is liable to the carrier for any damage occasioned by the absence, insufficiency or irregularity of any such information or documents [Rule 16(1)].

The consignor is responsible for the correctness of the particulars and statements relating to the cargo which he inserts in the air waybill. He will be liable to indemnify the carrier against all damage suffered by him, or by any other person to whom the carrier is liable, by reason of the incorrectness or incompleteness of the particulars and statements furnished by him (Rule 10).

The air waybill is *prima facie* evidence of the conclusion of the contract, of the receipt of the cargo and of the conditions of carriage. The statements in the air waybill relating to the weight, dimensions and packing of the cargo, as well as those relating to the number of packages, are *prima facie* evidence of the facts stated; those relating to the quantity, volume and condition of the cargo do not constitute evidence against the carrier except so far as they both have been, and are stated in the air waybill to have been, checked by him in the presence of the consignor, or relate to the apparent condition of the cargo (Rule 11).

It is important to note that the Act permits the issue of a negotiable air waybill (Rule 15(3)].

Right of disposition of the consignor (Rule 12). The consignor has the

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right to dispose of the cargo by withdrawing it at the aerodrome of departure or destination, or by stopping it in the course of the journey on any landing, or by calling for it to be delivered at the place of destination or in the course of the journey to a person other than the consignee named in the air waybill, or by requiring it to be returned to the aerodrome of departure. He must not exercise this right of disposition in such a way as to prejudice the carrier or other consignors and he must repay any expenses occasioned by the exercise of this right.

If it is impossible to carry out the order of the consignor the carrier must so inform him forthwith.

If the carrier obeys the orders of the consignor for the disposition of the cargo without requiring the production of the part of the air waybill delivered to the latter, he will be liable, without prejudice to his right of recovery from the consignor, for any damage which may be caused thereby to any person who is lawfully in possession of that part of the air waybill.

The right conferred on the consignor ceases at the moment when that of the consignee begins in accordance with Rule 13 (discussed under next sub-heading). Nevertheless, if the consignee declines to accept the waybill or the cargo, or if he cannot be communicated with, the consignor resumes his right of disposition.

Rights of the consignee (Rule 13). (1) Unless it is otherwise agreed the consignee has the right to receive notice from the carrier as soon as the cargo arrives at the place of destination.

(2) The consignee is entitled on arrival of the cargo at the place of destination to require the carrier to hand over to him the air waybill and to deliver the cargo to him, on payment of the charges due and on complying with the conditions of carriage set out in the air waybill.

(3) If the carrier admits the loss of the cargo, or if the cargo has not arrived at the expiration of seven days after the date on which it ought to have arrived, the consignee is entitled to put into force against the carrier the rights which flow from the contract of carriage.

Liability of the Carrier

The carrier by air is liable to pay damages in the following cases:

1. The carrier is liable for damage sustained in the event of the death or wounding of a passenger or any other bodily injury suffered by a passenger, if the accident which caused the damage so sustained took place on board the aircraft or in the course of any of the operations of embarking or disembarking (Rule 17).

2. The carrier is liable for damage sustained in the event of the destruction or loss of, or of damage to, any registered baggage or any cargo, if the occurrence which caused the damage so sustained took place during the

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'carriage by air'. The term *carriage by air* here comprises the period during which the baggage or cargo is in charge of the carrier, whether in an aerodrome or on board an aircraft, or, in the case of a landing outside an aerodrome, in any place whatsoever (Rule 18).

3. The carrier is also liable for damage occasioned by delay in the carriage by air of passengers, baggage or cargo (Rule 19).

Limitations of the carrier's liability. Under the following circumstances, the carrier is not liable for damages:

(i) If he proves that he and his servants or agents have taken all necessary measures to avoid the damage or that it was impossible for him or them to take such measures (Rule 20).

(ii) If he proves that the damage was caused by or contributed to by the negligence of the injured person. In this case, the Court may, in accordance with the provisions of its own law, exonerate the carrier wholly or partly from his liability (Rule 21).

Maximum liability. The liability of the carrier is limited to the following sums, under Rule 22 of the Second Schedule to the Act:

(a) In the carriage of persons, the liability for each passenger in case of death or injury is limited to the sum of 2,50,000 francs. In case of countries who have not yet signed the Hague Protocol and therefore are governed by Warsaw Convention Rules as contained in the First Schedule to the Carriage by Air Act, 1972, the liability for each passenger is limited to the sum of 1,25,000 francs.[3] But by special contract, the carrier and the passenger may agree to a higher limit of liability.

(b) In the carriage of registered baggage and of cargo, the liability in case of its loss, damage or delay is limited to a sum of 250 francs per kilogramme, unless the passenger or consignor has made, at the time when the package was handed over to the carrier, a special declaration showing the value of package and has paid additional freight if the case so requires. In that case the carrier will be liable to pay a sum not exceeding the declared sum, unless he proves that the declared value is greater than the real value at the time and place of delivery.

In the case of loss, damage or delay *of part* of registered baggage or cargo, the weight to be taken into consideration in determining the amount to which the carrier's liability is limited shall be only the total weight of the package or packages concerned. But, when the loss, damage or delay of a part of the registered baggage or cargo affects the value of other packages covered by the same 'baggage check' or the same 'air waybill',

[3]In case of non-international or domestic carriage by air the carrier's liability for each passenger is limited to Rs 1,00,000 and if the passenger is below 12 years liability is reduced to Rs 50,000.

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the total weight of such package or packages shall also be taken into consideration in determining the limit of liability.

(c) As regards objects of which the passenger takes charge himself, the liability is limited to 5,000 francs per passenger.

Any sum in 'francs' mentioned in the limits of liability stated above shall, for the purpose of any action against a carrier, be converted into rupees at the rate of exchange prevailing on the date on which the amount of damages to be paid by the carrier is ascertained by the Court (Sec. 6 of the Carriage by Air Act, 1972).

Any provision tending to relieve the carrier of liability or to fix a lower limit than that which is laid down under Rule 22 stated above shall be null and void except where the liability is excluded for loss or damage resulting from the inherent defect, quality or vice of the cargo carried (Rule 23).

It may further be noted that the limits of liability specified above shall not apply if it is proved that the damage resulted from an act or omission of the carrier, his servants or agents, done with intent to cause damage or recklessly and with knowledge that damage would probably result; provided that, in the case of such act or omission of a servant or agent, it is also proved that he was acting within the scope of his employment (Rule 25).

Procedure for realising damages. *In the case of damage*, the person entitled to delivery must complain to the carrier forthwith after the discovery of the damage, and, at the latest, within seven days from the date of receipt *in the case of baggage* and fourteen days from the date of receipt *in the case of cargo* [Rule 27(2)].

In the case of delay, the complaint must be made at the latest within twenty-one days from the date on which the baggage or cargo have been placed at the disposal of the carrier [Rule 27(2)].

Every complaint must be made in writing upon the document of carriage or by separate notice in writing despatched within the times aforesaid. Failing complaint within the times aforesaid, no action shall lie against the carrier, save in the case of fraud on his part [Rule 27(3)(4)].

The suit for damages must be filed, at the option of the plaintiff, in the territory of one of the High Contracting Parties, either before the Court having jurisdiction where the carrier is ordinarily resident, or has his principal place of the business or has an establishment by which the contract has been made, *or* before the Court having jurisdiction at the place of destination (Rule 29). Further the suit must be filed within two years of the date of arrival of the aircraft at the destination *or* the date on which the aircraft ought to have arrived *or* the date on which the carriage stopped, otherwise the right to damages shall be extinguished (Rule 30).

In the case of carriage to be performed *by various successive carriers* and regarded as one undivided carriage as per Rule 1(4), each carrier is

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deemed to be one of the contracting parties to the contract of carriage insofar as the contract deals with that part of the carriage which is performed under his supervision. In the case of carriage of this nature:

(a) suits for damages for death or injury to the passengers are to be filed against the carrier who performed the carriage during which the accident occurred, except in the case where, by express agreement, the first carrier has assumed liability for the whole journey; and

(b) suits for damages for loss or damage to baggage or cargo are to be filed by *(i)* the passenger or consignor against the first carrier, *(ii)* the passenger or consignee against the last carrier, and further, each may take action against the carrier who performed the carriage during which the destruction, loss, damage or delay took place. These carriers will be jointly and severally liable to the consignor or consignee or to the passenger (Rule 31).

TEST QUESTIONS

1. What 'documents of carriage' are to be issued, when goods and passengers are carried by air under the Second Schedule to the Carriage by Air Act, 1972? Discuss fully.

2. Under what circumstances the carrier in an international carriage by air is liable to pay damages? What are the limitations of such liability? What is the maximum amount of liability that can be imposed under the Second Schedule of the Carriage by Air Act, 1972?

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PART VIII

Law of Arbitration

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Chapter 42

General Provisions Regarding Arbitration

The law relating to arbitration is presently contained in the Arbitration Act, 1940,[1] which came into force on 1st July 1940. It repeals the Indian Arbitration Act, 1899 and the Second Schedule to the Code of Civil Procedure, 1908 which governed the law relating to arbitration earlier. The Act extends to the whole of India except the State of Jammu and Kashmir.

Arbitration Defined

An arbitration may be defined 'as the settlement of disputes and differences relating to civil matters (*e.g.*, money or property or breach of contract) between one party and another in a quasi-judicial manner, by the decision of one or more persons, called arbitrators, appointed by the contending parties, without having recourse to a Court of law'. The essence of arbitration, therefore, is that it is the arbitrator(s) who decides the case *out of Court,* though Court may have to intervene to regulate arbitration proceedings, or, to give the '*award*' or judgement of the arbitrator sanction of law.

The practice of referring matters to a *Panch* or settling disputes by arbitration has always been a widely used method of deciding many a dispute in our country. The corresponding words for 'arbitrator' and 'arbitration', *i.e.*, *Panch* and *Panchayat* are probably as old as Indian history. The word *Panchayat* suggests a proceeding before a specified number of persons (generally five persons), who act as the sole and final judges of the matter referred to them by the opposing parties for decision.

The method of settling disputes through arbitration possesses certain

[1]Throughout Part VIII of this book (*i.e.*, Chapters 42-43), which deals with the Law of Arbitration, the references to Sections, unless otherwise specifically stated, are references to Sections of the Arbitration Act, 1940. The word 'Act' wherever used means the Arbitration Act, 1940.

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merits as compared to a suit in a regular Court of law. It is less costly. It saves time and irritation arising from delays in court proceedings. It is much more simple in procedure. Moreover, the 'award' of the arbitrator, once approved by the Court, is final and no appeals lie from it. Hence, commercial contracts frequently contain an 'arbitration clause' providing for a reference to arbitration in case of any dispute relating to the contract.

Arbitration Agreement

An 'arbitration agreement' means "a written agreement to submit present or future differences to arbitration, whether an arbitrator is named therein or not" [Sec. 2 *(a)*]. Thus, the essentials of a valid and binding arbitration agreement are as follows:

1. *The agreement must be in writing.* To be valid, the terms of an arbitration agreement must be expressed in writing. It is, however, not necessary that the agreement must be contained in a formal document executed by both the parties thereto, nor is it required to be signed by both of them (*Banarsi Das* vs *Cane Commissioner*[2]). The agreement may be gathered from several documents, or event be inferred from correspondence between the parties, and it is enough if one party signs the written submission and the other accepts it either in writing or orally or by conduct. What is required is that the terms of the arbitration agreement must be reduced in writing and it must be established that the parties agreed to the settlement of disputes by arbitration. Thus, if an arbitration clause is included in an indent, and goods are supplied in pursuance of the indent, and even the bills prepared by the seller are with reference to the indent, there would be an arbitration agreement in existence between the parties (*Shalimar Paints* vs *Omprakash Singhania*[3]).

2. *The agreement should be to refer either a present or future dispute to arbitration.* The existence of a dispute or difference is essential to the validity of a reference to arbitration. If the agreement was entered into with respect to future differences, no reference to arbitration can be made until such differences have arisen and unless they are still subsisting. If there is no dispute, the arbitration agreement will not operate. Thus, where a demand is made by a creditor on a debtor to pay the amount due and the debtor while admitting his liability requests for extending the time for payment, there is no dispute which may be referred to arbitration and the creditor would be entitled to file a suit in the Court for his money, though the transaction out of which the debt arose contains an 'arbitration clause'

[2]A.I.R. (1963), S.C. 1417.
[3]A.I.R. (1967), Cal. 372.

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(*Rai & Sons* vs *Poysha Industries*[4]). Therefore, the *arbitration clause* is not in a sense an integral part of the contract. A contract with an *arbitration clause*, rolls, as it were, two contracts into one.

It is worth noting that in spite of a dispute concerning a contract containing an arbitration clause, the parties are not bound to have recourse to arbitration. They may settle the dispute directly and agree not to invoke the arbitration clause for that purpose. They may also enter into a substituted agreement in complete supersession of the original contract and thereby abrogate the contract and the arbitration clause contained in it (*Union of India* vs *Kishori Lal*[5]).

3. *It is not necessary that an arbitrator should be named in the arbitration agreement.* The name of person or persons who will act as arbitrator may be fixed after entering into the agreement of arbitration. But when fixed they should be fixed definitely. An arbitration agreement to refer to either *X* or *Y* is bad for uncertainty.

If the above conditions are satisfied, the arbitration contract is valid and it is immaterial whether or not the terms 'arbitration' or 'arbitrator' have been used in it. Of course, besides the above essentials, an arbitration agreement must have all the essential elements of a valid contract. For example, the parties must be *ad idem* on the question of reference of their own free will, the parties must be competent to contract, the terms must be definite and certain, the matter to be referred to arbitration must not be immoral, illegal or opposed to public policy. Thus, where all the parties interested in the matter of dispute have not consented to the arbitration clause or agreement, such an agreement is invalid and the 'award' will not bind even the consenting parties. Similarly, where the arbitration clause provided that in case of a dispute the same *can* be settled by a reference, it was held that it was not an agreement to submit disputes to arbitration for it lacked certainty as the words used do not indicate a determination to go to arbitration but a mere possibility (*Joti Brothers* vs *Shree Durga Mining Co.*[6]). Again, where there is an arbitration clause in an agreement void *ab-initio* or illegal, the arbitration clause is not binding. But where there is an arbitration clause in a contract which is avoided on the ground of fraud or misrepresentation, the arbitration clause remains operative (*State of Bombay* vs *Adamjee*[7]).

It may be mentioned that the term 'submission' was used in the sense of 'arbitration agreement' in the Acts relating to arbitration in India prior to the Arbitration Act of 1940.

[4]A.I.R. (1972), A.P. 302.
[5]A.I.R. (1953), Cal. 642.
[6]A.I.R. (1956), Cal. 280.
[7]A.I.R. (1951), Cal. 147.

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Effect of an Arbitration Agreement

With a view to promoting the sanctity of contracts, the Court ordinarily requires the parties to an arbitration contract to resort, for resolving disputes covered under the contract, to the tribunal contemplated by them at the time of the contract. Thus, if a party to an arbitration agreement disregards the agreement and files a suit in a Court of law with respect to the subject-matter of such agreement, the other party to the agreement has a right to file an application for *staying the suit* so as to enable arbitration to proceed in terms of the agreement. Section 34 of the Arbitration Act empowers the Court to make a *stay order,* if the following conditions are satisfied:

1. There must be a valid arbitration agreement in existence.
2. The suit must have been filed by a party to the agreement against another party to the agreement.
3. The subject-matter of the suit in question must be within the scope of the arbitration agreement.
4. The applicant for stay must be a party to the legal proceeding and he must have taken no steps in connection with the defence against the suit (*e.g.*, filing the written statement) after appearance.
5. It must also be shown that the party applying for stay was and is still ready and willing to proceed with the arbitration.
6. The Court must also be satisfied that there is no sufficient reason why the matter should not be referred to arbitration in accordance with the agreement.

It will thus be observed that mere existence of an arbitration agreement is no bar to a suit in a Court of law. But if all the above mentioned conditions are satisfied, the Court in which the suit is filed may stay the proceeding by making a stay order, so as to force the parties to abide by the arbitration agreement.

Who Can Refer Disputes to Arbitration?

As a general rule, capacity to make a 'submission' is co-extensive with capacity to contract. Thus, only those who have a general legal capacity to contract and also possess such power in relation to the subject-matter of the submission as will enable them to carry into effect any order which could be legally laid upon them by the 'award' can refer disputes to arbitration.

As *a minor or lunatic* is not competent to enter into a contract, there cannot be a valid submission to arbitration by him. But the natural or legal guardian of a minor or lunatic can refer disputes to arbitration on his behalf, provided he acts in good faith and for the benefit of the minor or lunatic. (A *de facto* guardian can do so only with the leave of the Court.) A *partner* in a firm cannot refer a matter in dispute to arbitration on behalf of the firm unless he is so authorised by the Partnership agreement or by usage or

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custom of trade. A *joint stock company* cannot refer disputes to arbitration. The *Karta* of a *joint Hindu family,* acting *bonafide,* may enter into an arbitration agreement on behalf of the family so as to bind other coparceners. An *agent* cannot refer disputes to arbitration unless specially authorised. An *attorney or a solicitor* engaged in a case has no implied authority to refer the dispute to arbitration unless he is specially authorised for that purpose in writing by the terms of his *vakalatnama.* An *Official Assignee or a Receiver* can make a valid submission with the permission of the Court, but the insolvent cannot as he is incapable of dealing with his property. Under Section 43 of the Indian Trusts Act, a *trustee* has the power to submit disputes to arbitration unless a contrary intention is expressed in the instrument of trust.

The death of any party to an arbitration agreement will not affect the agreement, it will continue to be enforceable by or against his legal representatives except in such cases where the right of action is extinguished by his death, *e.g.*, where the cause of action is based on tort and the wrongdoer dies before the award is made, it will not be binding on the heirs of the deceased party. Where the right to sue or be sued survives and is not extinguished by the death of a party, his heirs shall continue to be bound by the arbitration agreement (Sec. 6). But if a party dies *during arbitration proceedings* (*i.e.*, before the hearing has been concluded), his legal representatives must be brought on record or given notice of the proceedings, otherwise they cannot be made bound by those proceedings.

What May be Referred to Arbitration?

Generally speaking, all matters in dispute which can be decided by civil court, with a few exceptions given below, may be referred to arbitration. Disputes relating to matters which are purely criminal in nature cannot be referred to arbitration because if such disputes are allowed to be referred to arbitration, the resultant arbitration agreement shall be in the nature of 'an agreement stifling *criminal prosecution*'[8] which is void under Section 23 of the Indian Contract Act as its object is unlawful.

What can be referred? The following matters can be validly referred to arbitration:

1. Matters of a civil nature, *e.g.*, disputes about property or money, disputes arising out of breach of contract, questions of law.

2. Matters relating to personal rights between the parties, *e.g.*, a question of marriage or maintenance payable to wife, terms of separation between husband and wife.

[8]An arbitration agreement entered into for the settlement of *civil disputes* is valid even though in pursuance of such an agreement the prosecution is dropped [*Harjas Rai* vs *Tek Chand,* A.I.R. (1927), L.C. 468].

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3. Disputes regarding dignity and respect.

4. Time-barred claims.

What can't be referred? The following matters cannot be referred to arbitration:

1. Disputes relating to matrimonial relations like a suit for divorce or restitution of conjugal rights.

2. Testamentary matters, *e.g.*, the question of genuineness or otherwise of a 'will'.

3. Insolvency matters, *i.e.*, adjudging a person as an insolvent.

4. Questions relating to Trusts for public purposes of a charitable or religious nature.

5. Matters relating to the guardianship of a minor or a lunatic.

6. Criminal matters and disputes.

Disputes relating to matters specified above affect public at large and therefore must be decided by a Court of law.

TEST QUESTIONS

1. Define the term arbitration. What is an arbitration agreement? Discuss the requisites of a valid arbitration agreement. Is it necessary to name an arbitrator in the arbitration agreement?

2. Discuss the essential elements of an arbitration agreement. What is the effect of an arbitration agreement?

3. Who may refer disputes to arbitration? What matters can and what matters cannot be referred to arbitration?

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. *A*, *B* and *C* carry on partnership business. A dispute about partnership accounts is referred to arbitration by *A* and *B*. Is the reference competent?

[Hint. As all the parties interested in the matter of dispute are not *ad idem* on the question of reference, the reference is invalid and the 'award' will not bind even the consenting parties.]

2. *X* was robbed of his watch by *Y*. *X* institutes a suit against *Y* for robbery. Later, on persuation of a common friend both *X* and *Y* agree to refer the matter to arbitration and *X* promises to drop the prosecution. Is the arbitration agreement valid?

[Hint. No, the arbitration agreement is void, because robbery is a criminal matter and as such cannot be the subject of arbitration.]

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Chapter 43

Modes of Arbitration

The Arbitration Act deals with three modes of Arbitration, namely,

I. Arbitration without intervention of court.
II. Arbitration with intervention of court where no suit is pending.
III. Arbitration with intervention of court where a suit is pending.

We shall now deal with these modes one by one in detail.

ARBITRATION WITHOUT INTERVENTION OF COURT

In this mode, the arbitration proceedings proceed upto the stage of making of the 'award' by the arbitrators without the intervention of the court. An award made by the arbitrators amounts to a settlement of the dispute by mutual agreement and becomes binding on all the parties to the arbitration agreement. But, for giving an award the force of a judgement of a court, the arbitrators may be required to file the same in writing in the court. Thereupon the court examines the validity of the award and, in fit cases, pronounces judgement according to the award and passes a decree. The award then becomes legally binding on all the parties to the arbitration agreement. It may be noted that if something goes wrong during the progress of the arbitration proceedings, the court has authority to intervene even at an earlier stage, *e.g.*, where the arbitrators are found guilty of misconduct or carelessness, the court can remove them and appoint others in their place.

Provisions Implied in an Arbitration Agreement

The parties to an arbitration agreement are free to incorporate any terms and conditions they like in the arbitration agreement with respect to arbitration proceedings. But due to lack of care or foresight, an arbitration agreement may not set out each and every detail necessary for the completion of the arbitration proceeding and that may prevent the arbitration to be proceeded with. Section 3 therefore provides that unless otherwise expressly negatived by the arbitration agreement, the provisions set out in the

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First Schedule will be implied in every arbitration agreement.

The First Schedule of the Arbitration Act provides that, *subject to agreement among parties,* an arbitration agreement shall be deemed to include the following terms:

1. The reference[1] shall be to a sole arbitrator.

2. If the reference is to an even number of arbitrators, the arbitrators shall appoint an Umpire not later than one month from the latest date of their respective appointments.

The term 'umpire' means a third person who is to decide a controversy or question submitted to arbitrators in case of their disagreement. Thus, the Umpire's authority commences when arbitrators are unable to agree (*i.e.*, when there is a tie between an even number of arbitrators). An Umpire is invested with the same powers as the arbitrators, and has to perform the same duties.

It is worth noting that an Umpire may be appointed by the parties themselves under the arbitration agreement and it is only when the agreement is silent that arbitrators are required to appoint an Umpire. Further, one of the persons appointed as arbitrators cannot at the same time be appointed an Umpire (*Kafurchand* vs *Jewraj*[2]).

3. The arbitrators shall make their award within four months after entering on the reference or after having been called upon to act by notice in writing by any party to the arbitration agreement or within such extended time as the court may allow.

4. If the arbitrators do not make an award within the time mentioned above, or if they deliver a notice in writing to any party to the arbitration agreement or to the Umpire stating that they cannot agree, the Umpire shall forthwith enter on the reference in lieu of the arbitrators. The Umpire must re-hear the evidence if so requested by the parties.

5. The Umpire shall make his award within two months of the entering on the reference or within such extended time as the court may allow.

6. The parties to the reference and all persons claiming under them shall, if so required by the arbitrators or the Umpire, submit to be examined by them upon oath or affirmation in relation to the matters in difference and shall produce before them all necessary books, deeds, papers, accounts, writings and documents, and do all other things which, during the proceedings on the reference, the arbitrators or Umpire may require.

7. The 'award' shall be final and binding on the parties and persons claiming under them respectively.

[1] 'Reference' means a reference to arbitration [Sec. 2*(e)*].
[2] A.I.R. (1932), Cal. 491.

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8. The costs of the reference and award shall be in the discretion of the arbitrators or Umpire who may direct to, and by whom, and in what manner, such costs or any part thereof shall be paid, and may tax or settle the amount of costs to be so paid or any part thereof and may award costs to be paid as between legal practitioner and client.

The Appointment of Arbitrators

Who may be appointed? Law does not prescribe any qualifications for an arbitrator. It is open to the parties to appoint any person of *sound mind* as an arbitrator. They may choose an incompetent or unfit person to be an arbitrator, for every person is at liberty to choose one whom he likes best to be his judge. Corporate bodies and association of persons may be appointed arbitrators. Even a person interested in the subject-matter of dispute or in one or more of the parties (being a relation or friend) may be appointed an arbitrator provided his interest is well known to the parties before they sign the submission. Subsequent acquisition of interest or concealed interest in the subject-matter of the reference disqualifies an arbitrator from continuing with his work (*Blanchard* vs *Sun Fire Office*[3]). Similarly, undisclosed relationship of an arbitrator to one of the parties will affect the validity of an award (*Trustees of the Firm of Motharam Dowlatram* vs *Firm of Mayadas Dowlatram*[4]). There is no specific prohibition against a minor acting as an arbitrator, but since he has to execute an award, which may even require registration he should presumably also be major.[5] But such persons as are not amenable to the jurisdiction and control of the court, *e.g.*, a supreme head of the State, cannot be appointed arbitrators (*Kerala Thampuran* vs *Achutha Marar*[6]).

Parties should be very careful in the matter of appointment of arbitrators, for if the original appointment is bad, the award would be null and void. Normally such persons who are impartial and in whom the parties have complete confidence must be selected to act as arbitrators.

How arbitrators may be appointed? Arbitrators may be appointed in any of the following ways:

1. *Appointment by the parties.* The general rule is that the parties to the dispute select the arbitrator or arbitrators by *mutual consent.* The name of person or persons who will act as arbitrator(s) may or may not be mentioned in the agreement [Sec. 2*(a)*]. If either of the appointed arbitrators neglects or refuses to act, or is incapable of acting, or dies, the parties may, by

[3]6, T.L.R. 365.
[4]A.I.R. (1925) Sind. 150.
[5]*cf.* S.D. Singh, *The Law of Arbitration,* 7th Edn., p. 36.
[6]A.I.R. (1955), NUC (TC) 584.

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mutual consent, appoint a new arbitrator in his place.

2. *Appointment by third party* (Sec. 4). The parties to an arbitration agreement may also agree to the appointment of arbitrator or arbitrators by some third person designated in the agreement either by name or by office. For example, the parties may agree that the arbitrator or arbitrators shall be appointed by Mr A *or* Messrs C.D. *or* by the Delhi Stock Exchange or by the Principal, Shri Ram College of Commerce, Delhi.

3. *Power of a party to appoint new arbitrator or, in certain cases, a sole arbitrator* (Sec. 9). Where an arbitration agreement provides that each party to the dispute shall nominate one or more arbitrators and all such persons shall jointly act as arbitrators, then, unless a different intention is expressed in the agreement, —

(a) if either of the appointed arbitrators neglects or refuses to act, or is incapable of acting, or dies, the party who appointed him may appoint a new arbitrator in his place;

(b) if one of the parties fails to appoint an arbitrator, either originally or by way of substitution as aforesaid, within 15 clear days after the service by the other party of a notice in writing requiring him to make the appointment, such other party having already appointed his arbitrator before giving the notice may appoint that arbitrator to act as the sole arbitrator. The award given by such sole arbitrator shall be binding on both the parties as if he had been appointed by consent. On showing sufficient cause by the defaulting party, the Court, however, may set aside the appointment of Sole Arbitrator and *either* allow further time to the defaulting party to appoint an arbitrator *or* appoint an arbitrator on behalf of the defaulting party.

4. *Appointment by court* (Sec. 8). An arbitrator or umpire may be appointed by the court in any of the following cases:

(a) When the terms of an arbitration agreement provide that the arbitrator(s) shall be appointed by the consent of the parties, but the parties differ and do not concur in the appointment(s).

(b) When any appointed arbitrator or umpire neglects or refuses to act, or is incapable of acting, or dies, and the parties or the arbitrators, as the case may be, do not supply the vacancy so caused.

(c) Where the parties or the arbitrator are required to appoint an umpire and do not appoint him.

Procedure for appointment by Court. Any party may serve the other parties or the arbitrators, as the case may be, with a written notice to concur in the appointment or in supplying the vacancy. If the appointment is not made within 15 clear days after the service of the said notice, the Court may, on the application of the party who gave the notice and after giving the other parties an opportunity of being heard, appoint an arbitrator or arbitrators or umpire, as the case may be, who shall have like power to act

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in the reference and to make an award as if he or they had been appointed by consent of all the parties.

Appointment of three or more arbitrators (Sec. 10). Where an arbitration agreement provides that a reference shall be to three arbitrators, one to be appointed by each party and the third by the two appointed arbitrators, the agreement shall have effect as if it provided for the appointment of an umpire, and not for the appointment of a third arbitrator, by the two arbitrators appointed by the parties.

Where an arbitration agreement provides that a reference shall be to three arbitrators to be appointed otherwise than as mentioned above, the award of the majority shall, unless the arbitration agreement otherwise provides, prevail.

Where an arbitration agreement provides for the appointment of more than three arbitrators, the award of the majority, or if the arbitrators are equally divided in their opinions, the award of their umpire shall, unless the arbitration agreement otherwise provides, prevail.

Remuneration of Arbitrators or Umpire

An arbitrator or an umpire is entitled to his fees and charges payable in respect of the arbitration before he is required to publish his award or file it in the Court. The remuneration payable to an arbitrator or an umpire is generally fixed by agreement between the parties to the dispute and the arbitrator or arbitrators. If it is not fixed in the agreement, an arbitrator can fix up his own remuneration, but if he demands an unreasonable amount of fees, the parties may apply to the Court and the Court has authority to reduce it to a reasonable amount (Sec. 38). When reference is made through Court, the fees to be paid to an arbitrator should be fixed in the reference order itself. Where an arbitrator or umpire is removed by the Court for misconduct or carelessness, he shall not be entitled to receive any remuneration in respect of his services (Sec. 11).

Removal of Arbitrator or Umpire by Court

Under Section 11 of the Arbitration Act, the Court may, on the application of any party to a reference, remove an arbitrator or umpire who fails to use all reasonable dispatch ad diligence in entering on and proceeding with the reference and making an award. The Court may remove an arbitrator or umpire also on the ground that he has misconducted himself (*e.g.*, accepted bribe) or the proceedings (*e.g.*, heard only one party or refused to record oral evidence tendered).

Section 12 deals with the power of the Court in case of removal of an arbitrator or umpire. The Section lays down that where the Court removes an umpire or one or more of the arbitrators for misconduct or any other reason, it may appoint persons to fill the vacancies.

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Revocation of the Arbitrator's Authority

Once an arbitration agreement is arrived at, the parties cannot revoke the submission or the authority of an arbitrator or umpire except:

(a) when, all the parties to the dispute agree amongst themselves to revoke the arbitration agreement or the authority of an arbitrator, *or*

(b) when, at the instance of a party, the Court grants permission to such a course (Sec. 5). The Court will grant the permission to revoke a submission only under very exceptional circumstances, for example, when it is proved that the agreement has been obtained by fraud, undue-influence or coercion, *or* the appointed arbitrator or umpire is likely to show bias, or the arbitrator is guilty of misconduct or unreasonable delay. "Leave to revoke should be accorded to the applicant in all cases where he can establish that there will be the failure of justice if the reference is allowed to proceed" (*Bombay Insurance Co.* vs *Ahmad Bhai*[7]).

Effect of death of a party (Sec. 6). An arbitration agreement shall not be discharged by the death of any party thereto, either as respects the deceased or any other party, but shall in such event be enforceable by or against the legal representative of the deceased party. Further, the authority of an arbitrator shall not be revoked by the death of any party by whom he was appointed.

Effect of insolvency (Sec. 7). An arbitration agreement shall not be discharged by the insolvency of any party thereto. It shall be binding on the Official Assignee or Receiver, if he elects to adopt the contract.[8]

Powers of Arbitrators

The powers of an umpire are identical with the powers of arbitrators. Section 13 lays down that the arbitrators or umpire shall, unless a contrary intention is expressed in the arbitration agreement, have the following powers:

(i) to administer oath to the parties and witnesses appearing before him;

(ii) to refer matters of law or the award for the opinion of the Court;

(iii) to make the award conditional or in the alternative; (the general rule is that an award ought to be certain and definite but it is competent to an arbitrator to make a conditional award provided a provision is made by it for an alternative in case the condition is not fulfilled. For example, a dispute concerning the ownership of a diamond ring is referred to arbitration. The award may direct that the party in possession shall pay the

[7]I.L.R. 34, Bom. 1.

[8]Under Sec. 62(1) of the Presidency Towns Insolvency Act, the Official Assignee has the right to disclaim onerous or unprofitable contracts.

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other party Rs 1,000, the said sum to be reduced to Rs 5, if the ring is returned within fourteen days[9].)

(iv) to correct in the award any clerical mistake or error arising from any accidental slip or omission;

(v) to put necessary interrogatories to any party to the arbitration.

Besides the above powers, an arbitrator or umpire has also the following powers, unless otherwise agreed:

(a) to award interest upto the date of the Award;

(b) to determine by and to whom the costs of reference and the award shall be paid;

(c) to allow payment by instalments;

(d) to make an *interim award;*

(e) to order for the specific performance of the contract.

Duties of Arbitrators

Like powers, the duties of an umpire are also identical with the duties of arbitrators. The more important duties of arbitrators or umpire are as follows:

(i) To enter into the reference with all reasonable dispatch and make an award within the prescribed time.

(ii) To act impartially, as they hold a quasi-judicial position. An arbitrator should never consider himself to be the advocate of the cause of the party appointing him.

(iii) To observe the rules of evidence based on principles of natural justice. Thus, an arbitrator cannot rely upon evidence which is not binding on one of the parties, such as a previous statement recorded in his absence (*Mulk Rai* vs *Hem Raj*[10]). Both parties must be given a hearing after proper notice to them stating the date, time and place of hearing. An arbitrator ought not to hear or receive evidence from one side in the absence of the other side, without giving the other side affected by such evidence an opportunity of meeting and cross-examining the witness.

(iv) Not to misconduct themselves in any way, *e.g.*, accepting bribes or absenting from meetings amounts to misconduct.

(v) To act within the scope of their authority as expressed in the arbitration agreement.

(vi) To disclose to the parties before accepting the work of arbitration, if they have any interest in the subject-matter of dispute or in any party to the dispute.

(vii) Not to delegate their authority to somebody else. They must per-

[9]*Illustration* annexed to Sec. 15(2) of the Indian Arbitration Act of 1899.

[10]A.I.R. (1974). JK 40.

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form all functions personally except those of ministerial character.

(viii) Not to make use of their personal knowledge unless authorised to do so.

(ix) To be present at every meeting of arbitrators. Even where the parties agree that the award of the majority of arbitrators would prevail, it is essential that all the arbitrators must be present at all the meetings and at every stage of the proceedings. Absence of any of the arbitrators from a part of the hearing would vitiate the judicial character of the proceeding (*Badrilal* vs *Lakshya*[11]). But where the reference itself explicitly provides that in the event of some of the arbitrators being absent, the arbitration should be continued by the remaining arbitrators, the award made by them is a valid award (*Sita Ram* vs *Shanti Lal*[12]).

(x) The umpire is bound to re-hear the evidence and give the parties a fresh opportunity of presenting their respective cases before him, if so requested by the parties.

(xi) To sign the award and make it available to the parties or cause it to be filed in the court either at the request by any party to the arbitration agreement or if so directed by the Court, within a reasonable time.

The Award

A judgment or final decision of an arbitrator or arbitrators or an umpire on all matters referred to arbitration is called the 'award.' It should be in writing and signed by the arbitrators or umpire. No particular form or word is requisite for the validity of an award. Of course, an award must be the result of judicial decision and not arrived at by drawing lots or in some similar way. If it is the result of an absolute discretion exercised by a person, it cannot, by very nature of things, be an award (*V.C. Gandhi* vs *T.C Munshaw*[13]). Further, an award in order to be valid must be as final and certain as possible. If it is vague, it will be bad for uncertainty and, if it leaves undecided any important point, it is bad for want of finality. An award must also be compulsorily registered if it deals with immovable property of the value of Rs 100 or above unless it is delivered in a reference made through court, in which case it need not be registered (*Sher Bahadur* vs *Ram Narain*[14]).

The authority of arbitrators ceases as soon as an award is made, and no action of the parties by way of consent or otherwise would give the arbitrators authority to make a second award (*Pershottam* vs *Kekhusru*[15]).

[11]A.I.R. (1936), Nag. 29.
[12]A.I.R. (1952), VP 26.
[13]A.I.R. (1954), Bom. 121.
[14]A.I.R. (1945), Avadh. 1.
[15]A.I.R. (1934), Bom. 6.

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After making the award, the arbitrators or the umpire (as the case may be) shall give notice in writing to the parties notifying that the award has been made and signed. The notice should also mention the amount of fees and charges payable in respect of the arbitration and award [Sec. 14(1)].

Filing of award in court. In "arbitrations without intervention of the court," the arbitrators or the umpire (as the case may be) need not necessarily file the award in Court to give validity to it. If the award has been acted upon by the parties without filing it in Court and obtaining a decree on the basis thereof, it amounts to a settlement of the dispute by mutual agreement. However, for making an award equivalent to a judgment of a court of last resort, it must be filed in a court by the arbitrators or the umpire provided *(i)* they are so required to do by the parties to the arbitration agreement or they are so directed by the court, and *(ii)* the fees and charges due in respect of the arbitration and award and the costs and charges of filing the award have been paid to them. All depositions and documents which may have been taken and proved before the arbitrators or umpire must also be filed in court along with the award [Sec. 14(2)].

It is worth noting that in "arbitrations with intervention of the court" (discussed later), the arbitrators or umpire (as the case may be) are required to file the award in the court statutorily.

Proceedings after the award has been filed. After the award has been filed in court, the court must thereupon give notice to the parties of the filing of the award. Parties will be entitled to file objections against the award. The court has the power to modify or correct the award (on grounds mentioned in Section 15) *or* to remit the award for reconsideration upon such terms as it thinks fit (on grounds mentioned in Section 16) *or* to set aside the award (on grounds mentioned in Section 30).

But where the court sees no cause to remit, modify or set aside the award, it shall, after the time for making an application to set aside the award has expired, or such application having been made, after refusing it, pronounce judgment according to the award and a decree shall follow. Such a decree is *not appealable,* except on the ground that it is in excess of, or not otherwise in accordance with the award (Sec. 17).

Modification of the award (Sec. 15). The court may by order modify or correct an award on the following grounds only:

(a) where a part of the award is upon a matter which was not referred to arbitration and that part can be separated from the remaining part without affecting the decision on the matter which was referred to arbitration; or

(b) where the award is imperfect in form or contains an obvious error which can be rectified or amended without affecting the decision; or

(c) where the award contains a clerical mistake or an error arising from an accidental slip or omission.

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It may be noted that under this Section the Court has no power to go into the merits of the dispute and to alter or vary the award so as to convey a different decision from that awarded by the arbitrators. The Court can only modify or correct the award under conditions prescribed in clause *(a)*, *(b)* and *(c)* of this Section. Of course, the power of the court to modify and correct awards extend to awards in all types of arbitrations. Under Section 39(1) *(iii)*, an appeal lies from an order modifying or correcting an award.

Remitting the award (Sec. 16). Where there are omissions or defects in the award which are such as cannot be modified or corrected by the court itself under Section 15, the court may from time to time remit the award for reconsideration to the same arbitrators or umpire (as the case may be) upon such terms as it thinks fit. Under the Limitation Act, an objection to get an award remitted for reconsideration has to be filed within 30 days from the date of service of notice of filing the award.

The court is empowered to remit an award for reconsideration upon grounds specified below but upon no others:

(a) where the award has left undetermined any of the matters referred to arbitration, or where it determines any matter not referred to arbitration, and such matter cannot be separated without affecting the determination of the matters referred; or

(b) where the award is so indefinite as to be incapable of execution; or

(c) where an objection as to the legality of the award is apparent on the face of it.

Where an award is remitted for reconsideration, the court shall fix the time within which the arbitrators or umpire must submit the fresh award to the court. Such time may, however, be extended by the court from time to time. If no award is filed within the time allowed, the original award becomes void and ineffective.

When an award has so become void or has been set aside under Section 30 (discussed below), the court may by order supersede the reference and shall thereupon order that the arbitration agreement shall cease to have effect with respect to the dispute referred (Sec. 19). In such a case, the court will try the case itself.

An order remitting the award for reconsideration or refusing to remit the award does not fall within the purview of Section 39 and hence is not appealable.

Setting aside an award (Sec. 30). An application to get an award set aside has to be filed within 30 days from the date of service of the notice of filing the award in the court. Again, such an application can be moved only by a party, who has not accepted any benefit under the award and whose interests have been prejudicially affected (*Union of India* vs *Jai Narain Misra*[16]).

[16] A.I.R. (1970) S.C. 758.

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An arbitration, in substance, ousts the jurisdicition of the court except for the purpose of controlling the arbitrators and preventing misconduct and for regulating the procedure after the award. The court, therefore, has no right to review the decision contained in the award if the arbitrators have acted within their authority impartially and there is no legal misconduct on their part (*Dwarka Nath* vs *Kedar Nath*[17]). Section 30 provides, thus, that an award cannot be set aside except on one or more of the following grounds:

1. Where an arbitrator or umpire has misconducted himself or the proceedings.

Under the Arbitration Act, the word misconduct has two meanings: *(a)* moral turpitude, *i.e.*, bribery, corruption and fraud on the part of the arbitrator, and *(b)* legal or judicial misconduct. The latter includes cases where the arbitrator has failed to act in accordance with the duties and responsibilities of his office as laid down either by the law or by the arbitration agreement. For example, showing undue partiality in favour of one party, wrongfully refusing to hear a witness or a party, secretly acquiring an interest in the subject-matter of the arbitration, acting arbitrarily in complete disregard of the principles of natural justice amounts to legal or judicial misconduct. Legal misconduct is a valid ground for setting aside an award.

2. Where an award is made after the issue of an order by the court superseding the arbitration under Section 19 or after arbitration proceedings have become invalid under Section 35.

Under Section 19, the court is empowered to make an order superseding the reference, if the arbitrator or the umpire fails to reconsider and submit the award within the time allowed by the court. So an award made after the order of supersession is liable to be set aside. Under Section 35, arbitration proceedings become invalid when legal proceedings upon the whole of the subject-matter of the reference have been commenced between all the parties to the reference and a notice thereof has been given to the arbitrator or umpire and none of the parties have asked for stay of the legal proceedings. An award made after arbitration proceedings have become invalid may be set aside by the court.

3. Where an award *(a)* has been improperly procured *i.e.*, by coercion etc., or *(b)* is otherwise invalid *i.e.*, when the subject-matter of the reference is not capable of being referred to arbitration, or when the existence of an arbitration agreement cannot be proved, or when an arbitrator has been illegally and improperly appointed, or where the award is bad for want of registration, or where the award is not the result of judicial decision but has been arrived at by drawing of lots.

[17] A.I.R. (1954), Pat. 448.

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ARBITRATION WITH INTERVENTION OF COURT WHERE NO SUIT IS PENDING

Where there is an arbitration agreement, the parties have the option to proceed with the arbitration independently of any Court, in the manner described earlier, *or* apply to the Court under Section 20 and proceed with the arbitration under the supervision of the court. The latter course is usually adopted where difference regarding the actual jurisdiction of the arbitration agreement arises between the parties, *e.g.*, one of the parties holds the view that a particular matter of dispute cannot be referred to arbitration as per the agreement, while the other party differs. By resorting to this mode of submission (*i.e.*, initiating arbitration proceedings through court) the parties or any one of them may get all possible objections as to the subject-matter of the agreement cleared away at a very early stage, lest the whole proceedings of arbitration may go waste.

Section 20 of the Arbitration Act lays down the following procedure for having a reference made through court:

1. Where there is an arbitration agreement and no suit is pending, and where a difference has arisen to which the agreement applies, the parties or any of them may apply to a court having jurisdiction in the matter to which the agreement relates, that the 'arbitration agreement' be filed in Court.

2. On such application being made, the Court shall issue notice thereof to all the parties to the agreement other than the applicants, requiring them to show cause within the time specified in the notice why the agreement should not be filed.

3. Where no sufficient cause is shown, the Court shall order the agreement to be filed, and shall make an order of reference to the arbitrator appointed by the parties, whether in the agreement or otherwise, or where the parties cannot agree upon an arbitrator, to an arbitrator appointed by the Court.

4. Thereafter the arbitration shall proceed in the same manner as an 'arbitration without the intervention of the court' (discussed earlier).

ARBITRATION WITH INTERVENTION OF COURT WHERE A SUIT IS PENDING

Where a suit is pending before a court, the parties to the suit may decide to settle the matter by arbitration. Sections 21 to 25 deal with 'reference to arbitration where a suit is already pending' (*i.e.*, 'arbitration in suits') and provide as follows:

Where in any suit all the parties interested agree that any matter in difference between them in the suit shall be referred to arbitration, they

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may, at any time before judgment is pronounced, apply in writing to the Court for an order of reference.

On receiving such an application, the Court shall refer the matter to the arbitrators appointed in such manner as the parties agree, and lay down the time for the making of the award. After referring the matter to arbitration, the Court shall not, save in the manner and to the extent provided in this Act, deal with such matter in the suit, and the arbitration shall proceed in the same manner as an 'arbitration without the intervention of the court' (discussed earlier). It may be mentioned that only a part of the matter in issue in the suit may be made the subject-matter of reference, provided such part can be dealt with separately.

TEST QUESTIONS

1. What are the provisions implied in an arbitration agreement where the parties proceed with the arbitration without intervention of the Court?
2. Who may be appointed an arbitrator? What are the methods of appointment of an arbitrator? Also, state the provisions relating to the appointment of three or more arbitrators.
3. What are the powers and duties of an arbitrator?
4. Who is an Umpire? How is he appointed? What are his powers and duties?
5. What do you mean by an 'award'? How an award is made? Explain briefly the proceedings after the award has been filed in Court.
6. What are the grounds on which the Court can *(i)* modify or correct an award, *(ii)* remit an award for reconsideration, and *(iii)* set aside an award?
7. Explain the procedure for reference to arbitration with intervention of the Court *(i)* where there is no suit pending, and *(ii)* where a suit is pending.
8. Write notes on: *(a)* Legal misconduct of an arbitrator, *(b)* Arbitration in suits.

PRACTICAL PROBLEMS

Attempt the following problems, giving reasons for your answers:

1. A dispute arose between *P* and *Q* regarding possession of certain goods. They agreed to get this matter settled through arbitration and appointed *R* as an arbitrator. *R* proposed that the matter be decided by draw of lots. *P* wins the draw and claims the possession of the goods. *Q* challenges the award. Will he succeed?

[**Hint.** Yes, *Q* will succeed and the Court will set aside the award because a valid award must be the result of judicial decision.]

2. *A* and *B* appointed *M*, a person of 17 years, as their arbitrator to settle a dispute. Is the appointment of *M* valid?

[**Hint.** Although there is no specific prohibition against a minor acting as an arbitrator, but since he has to execute an award, which may even require registration, he should presumably be major. Therefore, the appointment of *M*, who is a minor, as arbitrator is invalid.]

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3. An arbitrator sends notice by registered post to parties to appear before him on a certain date. One of the parties fails to appear. The arbitrator records the evidence of the other party in his absence and gives an award. Examine the validity of the award.

[**Hint**. The award is valid and binding upon the parties, for although the arbitrator has recorded the evidence of one party in the absence of another party but the other party affected by such evidence has been given a proper notice to enable him to cross examine the opponent.]

4. An arbitrator dines with one of the parties in the absence of the other. Can this be treated as misconduct on the part of the arbitrator?

[**Hint**. Dining with one of the parties in the absence of the other does not amount to 'misconduct' of the arbitrator unless it is proved that the intention of the party was to corrupt or influence the arbitrator.]

5. Some matters in dispute between *A* and *B* were referred to arbitration of three named persons. The arbitrators held five meetings but one of the arbitrators could not be present at the two meetings. The arbitrators give their award by majority vote. Is the award valid?

[**Hint**. It is the duty of every arbitrator to be present at all the meetings and at every stage of proceedings. Absence of any of the arbitrator from a part of the hearing would vitiate the judicial character of the proceeding (*Badrilal* vs *Lakshya*, A.I.R. 1936, Nag. 29). The award, in the instant case, is therefore invalid.]

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